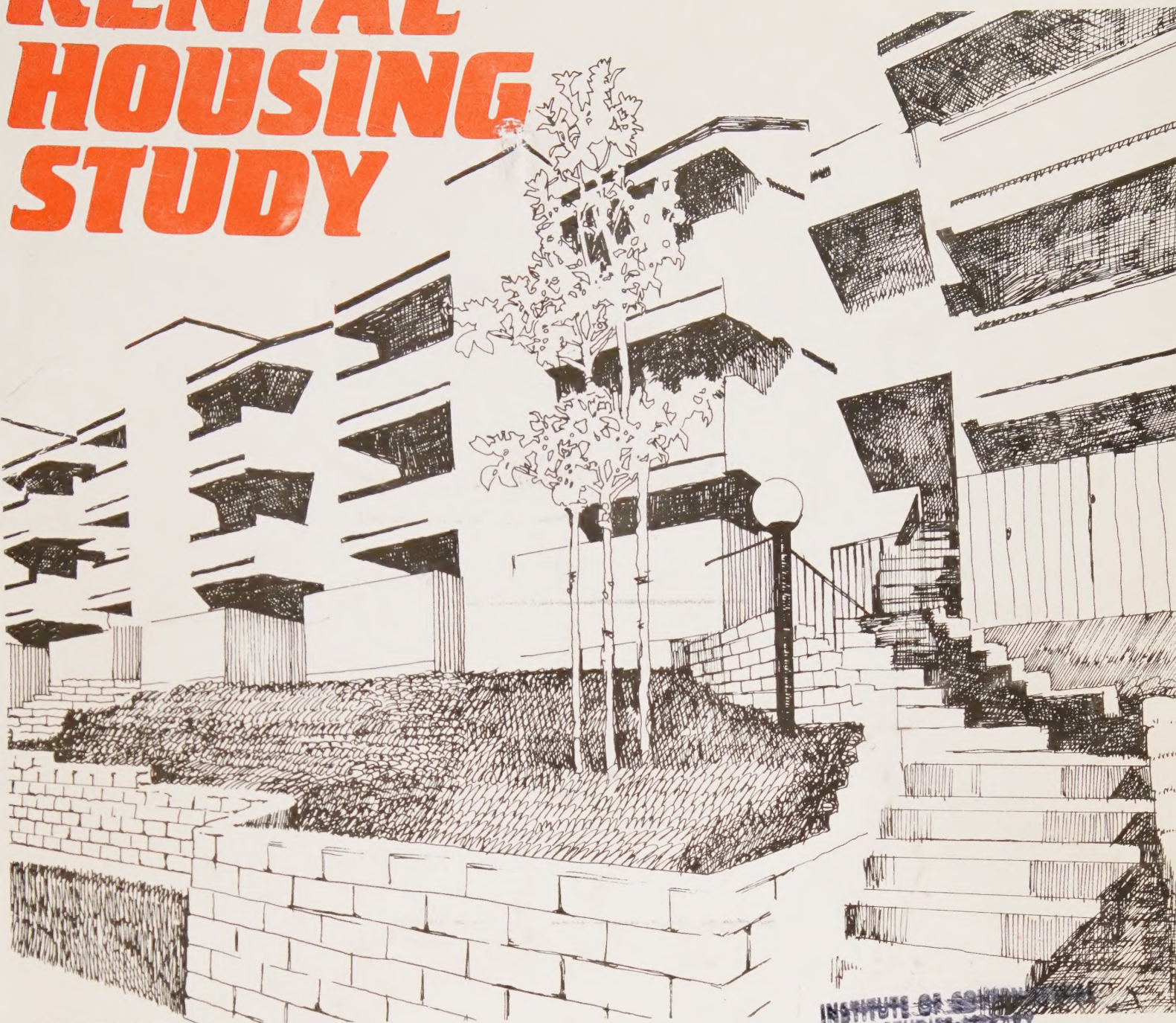


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RENTAL HOUSING STUDY



1984

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THE RENT STABILIZATION SYSTEM: IMPACTS AND ALTERNATIVES

Hamilton, Rabinovitz, Szanton & Alschuler

THE LOS ANGELES RENT STABILIZATION SYSTEM:
IMPACTS AND ALTERNATIVES

Prepared for
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Community Development Department
City of Los Angeles


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EXECUTIVE SUMMARY

THE LOS ANGELES RENT STABILIZATION SYSTEM:

IMPACTS AND ALTERNATIVES

Introduction

Rent stabilization has been in effect with respect to multi-family housing in the City of Los Angeles for the past six years. This Report presents the findings of a large scale research effort designed to provide City policy makers with facts, figures and analyses concerning the impact of rent stabilization on owners of residential property, on their tenants and on the public at large. It is also designed to assist policy makers to evaluate alternative formulas for setting maximum allowable annual rent adjustments for rent-stabilized dwellings in the future. Finally, the research assesses optional methods for directing the benefits of rent stabilization, or equivalent alternative benefits, to low income and senior citizens, as well as various ways of financing such optional programs.

Rent stabilization was not implemented in a vacuum. Many powerful economic and social factors influence the behavior of rents, the cost of shelter relative to other goods and services, the incentives to maintain housing, and citizen attitudes toward their housing situations. The period between 1977 and 1984 was among the most turbulent in American economic history, as measured by fluctuations in such basic economic indicators as GNP growth, price inflation and interest rate change. Sorting out the effects of these upheavals from those of rent stabilization can only be done in probabilistic terms.

The Impact of Rent Stabilization on Tenants

The Situation of Tenants under Rent Stabilization in Los Angeles

It is estimated that over 1.3 million tenants reside in some 489,000 units in the rent stabilized housing stock. Based on analysis of a survey of a statistically valid random sample of these tenants inside the City, and a sample of renters in the largest contiguous cities surrounding Los Angeles (Long Beach, Torrance, Pasadena, Glendale, Burbank and Inglewood) which do not regulate rents, the study finds that:

- * About two out of five tenants in Los Angeles do not know whether or not their dwellings are subject to rent stabilization.

- * Average rents in the City have risen only slightly more slowly during the period of rent stabilization than have average rents in surrounding unstabilized areas. The average annual

increase in gross rents (including utility costs) since the introduction of rent stabilization has been 10.9% per year inside Los Angeles, compared with 11.1% in the contiguous cities.

* The same has been true of overall rent-to-income ratios. Rents absorbed a larger share of household income in 1984 both inside and outside the City than they did in 1977. However, this trend has been if anything less pronounced in the City than in unstabilized areas.

-- The proportion of City rent stabilized households who spent more than 30% of their income on housing rose by 3.7%, to 37.4%, inside Los Angeles, compared to an increase of 7.2%, to 42.2%, in surrounding unstabilized areas. Put another way, the 1984 housing costs of well over one-third of all City tenants were "unaffordable" according to the affordability standards used at the Federal level, but an even larger proportion of the households in surrounding areas were in this situation.

-- Trends in the affordability of rents in the City were associated with how long a household had occupied its unit. Average rent-to-income ratios actually decreased for those who occupied their units for more than six years, while they increased for all other tenure subgroups.

-- In Los Angeles, the largest increases in the average share of income consumed by housing costs were experienced by Hispanic, Asian and other minority households, by larger households, and by households with incomes of more than \$10,000 but less than \$30,000 per year.

-- The smallest increases in the average share of income consumed by housing costs were experienced by households that had occupied the same units for at least six years, by senior citizens' households, and by single member households. Some of these subgroups experienced an average decrease in the share of income spent for housing.

-- Despite the decrease in average rent-to-income ratios among senior citizen households, these households still had the highest average ratios - 33% - of any age subgroup in the City in 1984. Among all demographic subgroups analyzed, only households with incomes under \$10,000 were spending more of their income -- 52% -- on rent.

* Tenants in the Los Angeles area seem to be moving less often than in prior decades, but the decline is generally no more pronounced in the City, where rents are stabilized, than in surrounding areas that do not regulate rents. The mobility of renters both inside and outside the City has declined sharply since 1977.

-- The percentage of long-tenured City tenants, i.e, those who have been in their units for six years or more, has nearly doubled since 1977, from 18% to 34%. There has been a similar, though slightly smaller, increase in the length of tenure of tenants outside the City as well.

-- Sixty one per cent of the tenants inside the City indicated that the affordability of available rental units was the most important impediment to moving.

* Average population density per unit is rising in all of the areas surveyed, whether or not rents have been stabilized. The incidence of more than one person per room has increased markedly both inside and outside the City. Whereas in 1977, 9% of City renters lived in such circumstances, today 16% do so. This trend is if anything more pronounced in contiguous unstabilized areas.

* Housing quality both inside and outside the City shows evidence of decline since 1977. Sixteen percent of Los Angeles tenants reported that there were three or more deficiencies, most of relatively minor nature, in their units. This compares to only 12% who reported such deficiencies in 1977. Again, however, returns from surrounding unstabilized areas were in the same direction and if anything more pronounced with respect to the more serious quality problems.

* Tenant households' ratings of their neighborhoods remained predominantly positive, nevertheless.

-- In 1977, 59% of City residents rated their neighborhoods as excellent or good; in 1984 the figure was 58%. The ratings were somewhat higher outside the City in both survey years, at 67% in 1977 and 72% in 1984.

-- Households with incomes of \$10,000 or less were the least satisfied.

-- Hispanic households reported the highest incidence of need in their units for repair, along with higher population densities than any other racial/ethnic group. Despite these perceptions, Hispanic households were more often satisfied with neighborhood quality than were members of other minority groups.

-- The sole attitudinal pattern that distinguished tenants of rent stabilized properties from those in non-stabilized ones was the tendency for people with longer tenure in stabilized units to be more satisfied with their units. Senior citizen households, and those who had resided in their units for six or more years, perceived less need for physical repair but were less satisfied with their neighborhoods than younger and more recently mobile households.

The Monetizable Costs and Benefits of Rent Stabilization

* Tenants perceive major financial benefits from rent stabilization. 83% of those who felt equipped to respond to questions about the financial effect the program had on them believed that their rents would be higher -- and usually much higher -- without stabilization.

-- If one totals the tenant estimates of the money savings flowing to them from rent stabilization the total net benefit to all tenants would be \$792 million a year.

-- This total is between 7 and 20 times higher than our estimates suggest that net benefits to all tenants actually were in 1984 (see below).

* Though rent stabilization has resulted in a net flow of subsidy from City landlords to City tenants that is not negligible, it is quite modest on a per-household basis; much of the substantial subsidies that do flow to some types of tenants is financed by payments by other tenants of premiums above what their rents would be if stabilization had not been enacted.

-- The overall subsidy effect of the form of rent stabilization practiced in Los Angeles is to charge higher rents for some units in order to permit lower rents to be charged for others.

-- Thus, some groups of tenants have benefitted more and others less from rent stabilization.

-- The primary determinant of the which tenants receive subsidy and which pay premiums is the length of the household's tenure in the unit since the enactment of stabilization. Those with the longest tenure receive the bulk of the subsidy delivered. Those who moved during 1982-83 pay the bulk of the premiums.

* The study uses two standards of comparison to measure rent stabilization benefit. The first assumes that in the absence of stabilization, rents in Los Angeles would have risen at the same rate as rents did rise in surrounding unstabilized areas. This standard is called "Imputed Rents." The second standard assumes that in the absence of stabilization rents would have risen to the levels represented by the rents charged to new tenants in City units that have been vacated recently. This we call "Market Rents." Benefits and costs are measured by subtracting the actual rent paid by tenants from each of these measures of unstabilized rents. This subtraction can yield a net cost as well as a net benefit from rent stabilization.

* The net flow of subsidy between all landlords taken as a group and all tenants taken together is not very imposing. Overall household savings average \$7 - \$18 per month, depending on

which standard of comparison one uses. These savings amount to between three-tenths and nine-tenths of one percent of household income.

* Because the stabilized sector is so large, however, the total number of dollars saved by those who received subsidies, even after the premiums paid by other tenants have been subtracted, comes to a considerable annual sum. The data indicate the total net subsidy is in the range of \$41-106 million per year.

* Still, using the criterion of 30% of income to represent housing affordability, between 12,000 and 25,000 households have housing costs that have been kept within the affordable range by rent stabilization. Again, however this is a net figure, meaning that 12-25,000 more households have been brought into the affordable range by net stabilization benefits than have been pushed out of that range by the net costs of stabilization in the form of premiums above unregulated rents.

* Those households that have not moved since the enactment of rent stabilization -- 34% of all households, or about 166,000 in total -- have realized substantial average savings in rents.

-- In 1984 these savings ran \$47 - \$55 per long-tenured household per month, on the average, or \$564 - \$660 per year. This represents 2.4% - 2.8% of household income.

-- If rent stabilization did not exist, the average rent paid by this group would be 14 - 16% higher than the rents they paid in 1984.

-- In 1984, these households received an estimated aggregate net savings of between \$79 million and \$113 million per year.

* A good deal of the subsidy to the long-tenured subgroup of tenants is financed by premiums above unstabilized rents paid by other tenant subgroups.

-- Those who have been in their units for 1-2 years are the prime subsidizers. They averaged rents of \$15 - 28 per month (or \$180 - \$336 per year) higher than the analysis indicates they would have been charged if there were no stabilization program.

-- Tenants with 3-5 years tenure appear to be just about breaking even in this respect.

-- When benefit calculations are based on the assumption that recent movers are paying the rents that would be charged if there were no stabilization, subsidies and premiums realized and paid by all tenure subgroups other than the longest-tenured largely cancel out, so the net overall

savings to all tenants from rent stabilization (\$106 million per year) are about the same as the estimated savings of long-tenured tenants taken alone (\$113 million).

* The long-tenured tenants tend to include an above-average concentration of white, senior citizen and single-person households. By contrast the subgroup that is financing much of the subsidy to these households is disproportionately young and comprised of larger households.

* The group receiving most of the subsidy and the group financing most of it through rent premiums are nearly identical as to income composition and racial/ethnic composition, with the important exception that the receiving group contains a smaller proportion of whites and a larger proportion of members of minority groups other than black or Hispanic. Within the white population, the subsidy is heavily concentrated in single member, senior citizen households.

* Households with incomes lower than \$30,000 in 1984 did average at least somewhat lower monthly rental than they would have had there been no rent stabilization. Households with higher incomes appear to have paid higher average rents than they would have paid if there were no stabilization program. However,:

-- The only income subgroup of households headed by blacks which averaged a significant financial gain from rent stabilization was the subgroup with an income of less than \$10,000 per year.

-- No income subgroup of Hispanic households -- not even the poorest -- averaged any financial gain from rent stabilization if the standard of comparison is Imputed Rents, though if Market Rents are the standard, Hispanic households have received substantial net benefits.

-- White households with incomes under \$30,000 reaped net average benefits, but those in the upper income brackets experienced a significant average net cost.

* Rent stabilization also has non-monetizable benefits and costs. Stability in the rents charged seems to be the major non-monetizable benefit perceived by tenants.

The Impact of Rent Stabilization on Los Angeles Apartment Owners

The Situation of Los Angeles Apartment Owners

* There are about 489,000 stabilized rental housing units in the City of Los Angeles located on 70,000 properties. Half of the buildings contain 12 or more dwelling units. The key questions to be answered with respect to these properties are (1) What have been the effects of rent stabilization on annual rates of return from properties inside Los Angeles, compared to those

outside? (2) Are Los Angeles landlords under greater financial pressure in operating buildings than owners outside the City in non-stabilized areas? (3) How has the position of property owners changed since 1977?

* By most objective standards the majority of stabilized properties are in relatively good financial shape. While average rates of return have until recently been below those in unstabilized areas, returns on the average have been unfailingly positive. Similarly, while operating expense-to-income ratios may be higher than in surrounding areas, they are below national averages.

* The analysis indicates that adverse effects of rent stabilization on annual rates of return were largely confined to the first few years of implementation of the program, and that current returns are as high if not higher than those in surrounding areas. Los Angeles landlords who sold their properties immediately following the enactment of stabilization did receive a significantly lower rate of return than their counterparts in unstabilized areas, however.

* The national average for operating expense-to-income ratios in the apartment industry indicates that expenses represent 44% - 47% of income. Los Angeles landlords are operating below this ratio, although operating costs appear to be a slightly larger fraction of building income in the City of Los Angeles than in surrounding, unstabilized areas.

* Income has risen faster than expenses between 1977 and 1983, in the small sample within which these figures can be tracked. The result is that operating expense ratios have fallen from 49% to 40%. The key reason for the slow rate of growth in expenses is the impact of Proposition 13, which generated a 45% decline in tax expenses. This more than offset the continuing increases in other expense categories.

Rates of Return on Rental Housing

* The exact level of returns on rental housing is difficult to estimate. Returns on these properties can be estimated in several different ways. The simplest is the pre-tax return on the total value of the property. On this measure, the average rate of return between 1970 and 1984 was roughly comparable for buildings inside and outside the City, regardless of building types. But the two areas followed different paths to reach this result. How one evaluates this outcome depends on whether one finds equivalent performance in the two areas acceptable.

-- This measure tells us, on an annual basis, the gross level of return generated, on average, by a particular type of rental property. It does not account for the effects of the owner's financing costs or income taxes.

-- City and non-City returns have followed very different paths over time. They were similar during the early 1970s, but between 1978 and 1981, after rent stabilization was adopted, returns were lower inside Los Angeles. Then, from 1981 through 1983, properties inside the City produced higher rates of pre-tax return than those in surrounding jurisdictions without rent stabilization.

-- Returns vary greatly from year to year. For example returns on large properties inside the City ranged from an average loss of 1.3% in 1972, to a gain of 37% in 1979.

-- Returns vary somewhat by size of building, though the overall pattern is the same. Over the period the values of small buildings increased by 84% within the City and 106% outside, while the values of large buildings increased inside the City by 112% and outside by 148%.

* After-tax return, a second measure, can be calculated both on value and on the owner's equity in the property. After-tax rates of return exhibit the same pattern as simple, pre-tax returns on value. They were reduced immediately following the enactment of rent stabilization, but by the end of 1983 they were as high as or higher than those in surrounding unstabilized areas.

-- This measure comes closer to reflecting what landlords actually realized, but require us to make many assumptions which may or may not reflect the actual circumstances of a given property or owner.

-- During the period prior to rent stabilization, after tax returns on property value averaged about 14% on large properties and about 15% on small properties both inside and outside Los Angeles. For the entire period from the adoption of rent stabilization to 1983, average annual returns were 11% on small properties and 13% on large properties both inside and outside the City. The big difference occurred in the intermediate, 1978-80 period when returns on value were 8% in Los Angeles and 15% outside for small properties, and 15% inside compared to 23% outside for large properties. Since 1982, returns in Los Angeles have exceeded those in surrounding unstabilized areas.

-- After-tax returns are volatile on a year to year basis. They were consistently lower than pre tax returns (since taxes reduce cash flow and appreciation).

* A third measure of return is "internal" rate of return. This measure tells the same story. Los Angeles rental properties suffered a drop in their rates in the early years of stabilization, but rebounded in recent years to a 1984 position that was a bit below the performance of unstabilized areas for the period.

-- The internal rate of return on small properties inside and outside Los Angeles was 43-44% from 1970 to 1977, and for large properties 41% -44%. It fell for small properties to 8% from 1977 to 1981 in Los Angeles and 12% outside; for large properties to 13% inside and 16% outside. Recent returns were higher inside the City for small properties (8% compared to 4% for the 1981 - 84 period) and for large properties in that time period (7% compared to 2%).

-- Internal rates do not take into account the appreciation of property value until the property is sold, rather than recognizing appreciation each year. Thus, the rates tend to be lower till the property is sold than the annualized after-tax returns cited above.

Expense to Income Relationships

* Another important aspect of rental housing ownership is the ratio of income to expenses. Apartment owners must meet the operating costs of properties, some of which they cannot control, or property will deteriorate. They can raise rents to meet these costs within the limits of tenant incomes and rent ceilings. These relationships were explored through a survey of Los Angeles and non-Los Angeles landlords done specially for this study, and also through examination of three other large data sets. They can be reported both as absolute figures and as ratios.

* The Los Angeles landlords who responded to the survey indicated that their average gross income was about \$3,262 per unit per year, or \$272 per month. After expenses and financing were considered, pre-tax cash flow averaged \$551 per unit per year, or about \$46 per month.

-- About 5% of the properties in Los Angeles reported that the owner lost money on the building even before financing costs were taken into account.

-- About 30% reported that money was lost on the building after financing costs were paid.

-- This income is based on average reported rents which are considerably below those reported by tenants. The average contract rents reported by tenants were \$408 per month. Nothing in the data permits us to account for the difference.

-- The most noticeable differences among buildings was associated with time of purchase. Buildings bought after 1978 registered higher income, higher expenses and lower net operating income than those bought earlier. Recent purchasers reported a net pre-tax cash flow loss of \$119 per unit, compared to a net pre-tax gain of \$1,106 for longer-term owners, principally because the average financing

costs of recent purchasers were more than two and one half times as high as the financing costs of landlords who bought properties before early 1980..

* The national average for operating expense-to-income ratios for apartment housing is 44%-47%. Los Angeles landlords appear to be below that ratio, although operating expense ratios may be marginally higher in Los Angeles than in the cities outside who do regulate rents.

-- The survey reported 43% as the ratio of expenses to income in Los Angeles, compared to 33% outside. A second source says the ratios are essentially identical inside and outside the City, at 38% - 39%. A third source shows that the inside Los Angeles ratio is 41%. A fourth source sets ratios both inside and outside at 38%.

-- These ratios vary by size of building and date of purchase. Large buildings (with over 12 units) had higher average operating ratios than smaller buildings, according to the survey.

Changes between 1977 and 1984

* A small number of landlords reported detailed income and expenses for both 1977 and 1983. In this group, gross building income rose 66% between 1977 and 1983, or 8.8% per year. After expenses and financing were taken into account, this led to a 94% increase in net operating income, from about \$980 per unit in 1977 to about \$1,900 per unit in 1982. This increase primarily resulted from the low rate of increase in operating costs, which in turn reflected a decline in property taxes that resulted from Proposition 13. While other costs rose, property taxes declined by 45%, from an average of \$339 per unit in 1977 to \$186 per unit in 1983.

* In ratio terms, the operating expense-to-income ratio went from 49% in 1977 to 40% in 1983, according to the survey of Los Angeles landlords, a result consistent with conclusions from national surveys conducted within the Los Angeles area. Income has risen by 9% annually, compounded over the period. Most expenses have risen even faster. But real estate taxes fell by 45% over the period, accounting for most of the improvement in operating ratios.

* In addition to providing income and expense data, owners estimated the value of their properties and investments. The average owner had owned his property for 14 years; the value of his building had increased by about 107% in the period, and his equity has increased by about 52%. The ratio of net operating income to current value (called the capitalization rate) was about 17%. On a unit basis, estimated property values have doubled since the purchase date and equity has increased sixfold. The ratio of net operating income to current value for the average unit was 5.3%.

-- Since the number of landlords with information about 1977 and 1983 was small, other sources of data were also used to calculate historical rates of return. One data set (from the DAMAR Corporation) suggests average per-unit costs about 10% higher than did the landlords responding to the survey.

-- One-third of all rent stabilized properties, containing 20% of all stabilized units were owned free and clear, while 50% of properties and 64% of all units had one outstanding mortgage, and 17% or 16% of all units had two.

-- Fewer than one-quarter of the properties were likely to have quite volatile financing costs, which makes them potentially quite sensitive to changes in the rent adjustment mechanism. These properties had balloon or variable rate mortgages.

Alternative Rent Adjustment Formulas

* Six optional rent adjustment formulas were compared in order to analyze the impact of these formulas on tenants and on landlords. The formulas tested are:

(1) The all-item Consumer Price Index (CPI) for the Los Angeles metropolitan area .

(2) A fixed proportion of the CPI set to equal the ratio of building operating costs plus profit to operating income.

(3) The CPI for all goods and services other than shelter.

(4) A rate of return-based formula tied to mortgage interest rates and the return on tax exempt bonds.

(5) The current flat ceiling of 7% on the annual increase in the rental charged for an unvacated unit, plus an allowance for rent financed utilities.

(6) A cost-based index which relates rent increases to increases in operating and maintenance costs.

* Based on current price experience, the present 7% ceiling would yield the highest 1985 average gross rent for tenants (\$486 per month) and rent to income ratio (29.8%). The current 7% ceiling would also yield the greatest revenue gain to landlords, while the cost-based Index formula would generate the smallest. Again assuming continued mild inflation, the other formulas would produce average gross rents for tenants between \$467 and \$475 per month and generate lower rent-to-income ratios (28.5% to 29.1%).

-- Using 1983-1984 prices as a basis for projection, the lowest ceiling on 1985 rent adjustments (2.23%) is produced by the Cost Based index formula. The highest is produced by the 7% cap.

-- Despite the different experiences of different subgroups of tenants, the rank order of attractiveness among optional formulas in terms of benefit is likely to be the same for all tenant subgroups, regardless of their length of tenure.

-- Despite the fact that different types of buildings will experience differing revenue and net operating income changes, the ranking of relative attractiveness of the optional formulas is also likely to be the same for all landlords.

-- Either the CPI or Non-Shelter CPI formula would maintain the average financial rent benefit of stabilization to all tenants as a whole at roughly its current level. Continuation of the flat 7% ceiling could result in net costs to tenants. The percent of CPI formula, which does not allow an inflation pass-through for that portion of expenses represented by mortgage interest and principal payments, produces a rent increase about 40% lower than those derived from either the all item or the non-shelter component of the CPI. The effect of the cost index-based formula would be about the same.

* It is difficult to identify what rate of return is "fair" when calculating a rate of return formula designed to maintain a flow of investment into real estate. Using a formula which employed as a standard the return on low grade municipal bonds, or this rate in combination with the interest rate on second mortgages, would produce a mandatory reduction in rents in most years so substantial that it would strain building finances to the point of insolvency. This largely reflects the high average rate of capital appreciation of Los Angeles rental properties. The potential volatility of a rate of return standard would also threatens the rent stability and predictability prized by tenants.

* The formulas vary greatly over the long term in ease of administration. Of all the formulas considered here, except for continuation of a flat ceiling which requires no adjustment at all, the full CPI and non-shelter CPI are the easiest to implement, since they require the calculation of only a single number each year and the compilation of the Index is performed at another level of government. The cost-based formulas, on the other hand would require regular updating of data bases on actual building cost experience.

Alternatives and Supplements to Rent Stabilization

* A number of different programs could be enacted as alternatives to rent stabilization that would deliver similar benefits to those now delivered by stabilization. These include housing vouchers, subsidized new construction and conversion of existing properties to low-income cooperatives. However, delivering benefits equivalent to those now received by either low income or moderate income and elderly households would involve more dollars than the net subsidy now received by all rent stabilized tenants, because the net benefits received by the households targeted would not be offset by the premiums now paid by ineligible households. A source of funds that provides between \$83 and \$173 million would be required.

* The analysis indicated that at this level of funding all options tested would force a tradeoff between providing a small amount of help to each household in the target beneficiary groups, on the one hand, or bringing the housing costs of only a small minority of them into the affordable range. This reflects the fact that rent stabilization, whatever its other effects, has not brought anything like all low income and/or senior citizens households' rents into the range generally accepted as affordable.

* To supplement the benefits of stabilization so as to ensure that poor and senior citizen households spend no more than 30% of their incomes for housing, \$128 to 287 million would have to be raised in addition to the current flow of rent stabilization benefits.

* Several means to raise these funds were considered. These include a decontrol tax, a transfer tax on the sale of property, and an additional gross receipts tax. Supplemental funding might be provided by a vacancy tax, an annual unit tax, or by a tax on higher income renters who appear to be benefitting from stabilization. All of these options would involve substantially higher tax rates than have been traditionally levied in Los Angeles, and most would apply to tax bases composed of small portions of the population, so the burden would be sharply felt.

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THE LOS ANGELES RENT STABILIZATION SYSTEM: IMPACTS AND ALTERNATIVES

CHAPTER 1 INTRODUCTION AND STATEMENT OF PURPOSE

This Report presents the findings of a large scale research effort carried out under contract with the Rent Stabilization Division of the Community Development Department of the City of Los Angeles. The work was conducted by a consortium of firms led by Hamilton, Rabinovitz, Szanton and Alschuler, Inc. (HRS&A), which served as the prime contractor, and the Urban Institute, which designed and performed the basic analysis of the data assembled. Arthur Young & Company performed the data collection from property owners and audited those data for errors and omissions. Professional Research Organization, Inc. conducted the interviews in the telephone survey of tenants. However, all survey instruments and other substantive tools employed in both surveys were produced by the project leaders. A complete list of the names of members of the project team may be found at the end of the Report.

This Report covers all aspects of the rent-stabilized property sector in the City of Los Angeles other than that involving mobile homes. The mobile home situation is addressed in a companion Report.

1.1 Introduction

Sensible public policy toward rents charged on multifamily dwellings is among the most demanding of the challenges faced by urban governments. The commodity involved -- shelter -- is a basic necessity of existence. The people directly affected, both tenants and landlords, make up a large proportion of the total

population. The economic implications of the rents charged and the returns on investment received are crucial at all levels of analysis, from family budgets to the structure and dynamics of the local economy taken as a whole. It is unsurprising, in view of the scale and the fundamental nature of these issues, that they tend everywhere to generate deep convictions and high emotions, both of which are freely expressed in the political process.

This is as it should be. The policy choices to be made are never entirely dictated by facts or technical analyses, however orderly or sophisticated. The decisions must express value judgments that are necessarily subjective. Though a quantitative formula can reflect and implement a policy, no sensible policy can be made or explained if the formula is regarded as anything but an instrument to realize the balance among fundamental values that underlies it. Valid public policy must be rooted in the substantive aims of society, not in a futile hope that the facts and/or the instruments of policy implementation will in themselves decide the basic issues.

Having accepted this, however, there remains a critical role for fact-gathering and analysis. Value judgments can be translated into systematically effective policy only if policy-makers are deeply informed about the factual context and the likely effects of the options available to them. Luck may occasionally suffice, but consistent, long-term effectiveness is only probable if policy-makers have a sound base of information about the situation that they are trying to affect and the likely extent and mechanics of impact of each of the instruments they might use to carry out the will of the governed.

The Mayor and City Council of Los Angeles recognized this in their action, taken on November 14, 1983, authorizing a study of the Los Angeles multifamily rental housing market to be conducted under the direction of the General Manager of the Community Development Department. This study has been managed by the Department's Rent Stabilization Division, working with a Steering Committee of representatives of property owners, tenant groups,

organized labor and other knowledgeable parties. It has been carried out in part by the Division itself and in part by consultants and contractors.

The mandate of the Mayor and Council specified three broad target areas for study:

- * A documented basis for setting an objective formula for adjusting the maximum annual increase in the rents charged for stabilized units permitted by the City's Rent Stabilization Ordinance.
- * Analysis of possible alternative methods of directing the benefits of rent stabilization to low income and senior citizen tenants.
- * Development of statistically reliable information on a range of housing market performance indicators that were to include the following:
 - The range of contract rents charged for residential units and trends in that range over time.
 - Residential rental unit costs, including operating expenses and debt service.
 - Vacancy rates.
 - Rates of household mobility.
 - Population density rates.
 - The income levels of tenants.
 - Changes in the size and quality of the residential rental housing stock.

Additional later amendments to the initial action by the Mayor and Council called for analysis of the mobile home market, the rent-to-income ratios of tenants in relation to the subsidies received from rent stabilization, and the effects of the vacancy decontrol aspect of the policy established by the Ordinance.

This Report is part of the Division's response to this mandate. Accordingly, the purpose of the project and of this Report is not to propose policy but to build solid factual and analytic tools that duly elected and appointed City officials can use as they weigh the merits of each option. The extraordinarily complex nature of the subject matter makes this a tall order in

itself. We believe that this Report responds to that challenge. Nevertheless, it must be clearly understood that the construction of a data base and a set of instruments neither preempts nor obviates policy decisions. It can help a great deal by mapping the range of the feasible and equipping policy implementers to maximize their knowledge of the likely results of their actions, but these steps cannot eliminate or resolve conflict between fundamentally different value systems. That resolution must be left to the political process that was created for precisely that purpose.

1.2 Objectives of the Project

The basic objective of the project was to help the City to construct the data bases and the analytic infrastructure necessary to understand how the rental housing market for multifamily dwellings works, and to assess the municipal policy options available with respect to that market and the people involved in it. What this Report provides are (a) facts, systematically gathered, verified and retrievable by computer; and (b) analyses which probe the interrelations of these facts and the changes that have been or are likely to be generated by stated types of policy intervention. The task of the project team has been to collect the data and perform the analyses in the most effective manner permitted by the state of the revelant arts. It is not to protect or attack any particular ideology regarding rent regulation (or non-regulation), but to assemble accurate information and subject it to professionally designed analytic routines that reveal the practical outcomes of the approaches in which the City has some possible interest. The reader will find no excursions into theory nor any ideological exhortations from the contractor on the value questions that are for the City alone to decide.

Turning to the specifics, the first goal of the project was to assemble a series of data bases which equipped the project team, and subsequently the City, to:

- * Understand the trends and mechanics of the multi-family rental housing market and the impact of rent stabilization from the standpoint of property owners, tenants and the public at large.
- * Evaluate alternative formulas for setting annual allowable rent adjustments for rent-stabilized dwellings.
- * Assess optional methods for directing rent stabilization or equivalent alternative benefits to low income and senior citizens.

The second objective of the project was to develop a conceptual and operational approach to analyzing possible formulas governing rent adjustments in terms of their impacts on landlords, tenants and City revenues. The third objective was to evaluate each of the prototype formulas approved for analysis by the City and compare the likely impacts of each in the light of the data collected in the course of the project. The fourth and final objective of the effort was to report all findings and document them in orderly and comprehensive fashion.

This Report, together with its companion volume on the mobile home component of the rent-stabilized housing sector, summarizes the findings reached in the course of achieving the objectives set forth above. Another volume of Technical Appendices provides methodological analysis and further detail on many findings. The reader with a deep, technical interest in the topic is urged to review the Appendices as well. However, the team has exerted a substantial effort to make the body of the Report meet the needs of the non-technician if taken alone, while also remaining as comprehensible to that reader as is possible within the constraints imposed by a complex topic.

1.3 Structure of the Report

The document is organized into five Chapters. This Chapter presents a general statement of the context and the purpose of the enterprise. Chapter 2 looks at the central questions from the perspective of impacts on the tenants of rent-stabilized units in Los Angeles. It reports and analyzes the data received

in a large-scale telephone survey of tenant households inside and outside the City that was conducted by the project team in the last months of 1984. It also compares those returns with comparable data from the years before enactment of rent stabilization in order to measure trends as well as recent conditions.

Chapter 3 focuses on the perspective of the owner of rent-stabilized properties. It reports and analyzes both the data from preexisting data sets and the results of a written survey of landlords inside and outside of the City performed by the project team during the same period that tenants were being surveyed by telephone.

Chapter 4 is devoted to analysis of the likely past and future effects of six possible approaches to regulation of rent increases, the current flat ceiling on raises in the rent charged for units that have not been vacated and five optional formulas that might be adopted as options for a flat ceiling. This Chapter also examines the likely effect of a change in the current policy -- known as vacancy decontrol -- in which no limit is placed on the rent that can be charged to an incoming tenant moving into a vacant unit.

Chapter 5 addresses the probable effects and funding requirements of several types of subsidy programs that might be considered either as replacements for or as supplements to rent stabilization if another means were sought to target the financial benefits of stabilization more directly on particular beneficiary groups. The Chapter then discusses nine optional mechanisms for raising the funds necessary to finance these substitutive or supplementary programs.

Throughout the document the geographic units used in the analysis are the six Labor Market Planning Areas that have been established by the City. Since the boundaries of these Areas are not widely known, an Exhibit is provided at the end of this Chapter which shows them superimposed on a map of the City. The reader may wish to refer to this map in reviewing the findings presented.

Each Chapter attempts to interrelate the findings reported in the previous ones. Our purpose is not to compartmentalize the perspectives taken, but to meld them into the seamless whole that is reality. It is only when the full picture emerges that the makers of public policy have the proper factual and analytic framework in which to make their judgments. We hope and trust that this Report meets that rigorous test.

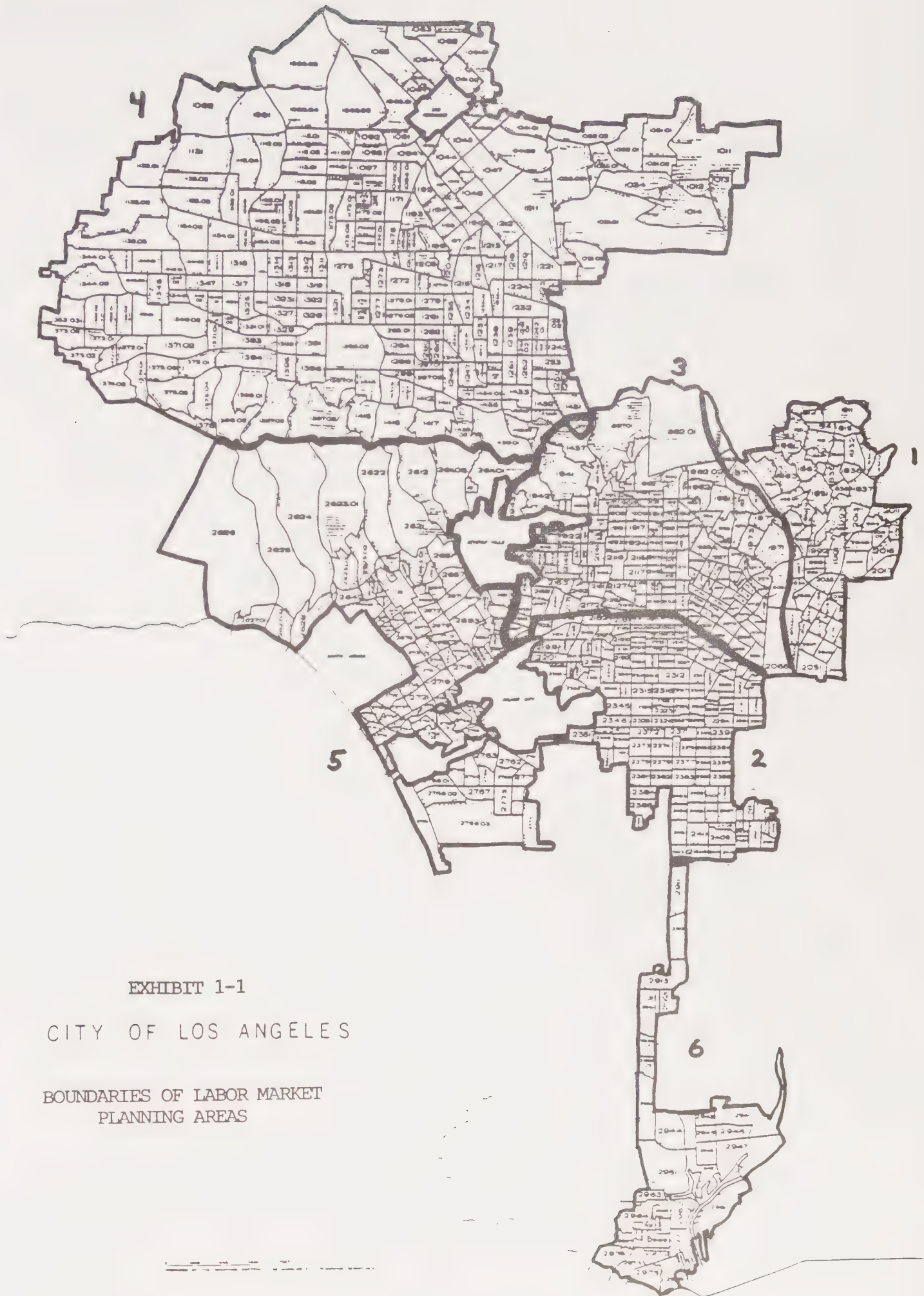


EXHIBIT 1-1

CITY OF LOS ANGELES

BOUNDARIES OF LABOR MARKET
PLANNING AREAS

CHAPTER 2

THE BENEFITS AND COSTS OF RENT STABILIZATION TO LOS ANGELES TENANTS

This Chapter examines the impact of rent stabilization on Los Angeles tenants who live in stabilized units other than mobile homes. Several key issues are addressed:

- * What is the current housing situation of the rent stabilized population in the City?
- * How has it changed since the enactment of rent stabilization?
- * What financial benefits and costs have accrued to this population as a result of rent stabilization?
- * What proportion of these benefits and costs apply to low income and/or elderly households?
- * What benefits and costs of a non-financial nature can be attributed to rent stabilization?

Documented answers to these questions are critically important to informed deliberations on rent stabilization policy of the kind that the Los Angeles City Council plans to undertake.

The Chapter has five principal sections. We begin by describing the data sets employed in the analysis. We then examine broad trends in the costs and quality of rental housing inside and outside the City during the period 1977 to 1984. The third section presents estimates of the benefits and costs that have resulted from rent stabilization which can be expressed in financial terms, while the fourth section examines other benefits and costs that do not lend themselves to financial expression. Finally, the Chapter concludes with a brief summary overview of our general findings.

2.1 The Tenant Data

Two data sets were used in the analysis of benefits and costs to tenants: the 1977 Annual Housing Survey (AHS) conducted under Federal auspices and including data on the Los Angeles area as part of a nationwide data base; and a 1984 survey of tenants in the Los Angeles area conducted specifically for this study.¹ Each data set was drawn from a random sample of renters inside and outside of the City of Los Angeles. However, due to the differing purpose of the two surveys, the "control" households (i.e., the households surveyed outside the City) were drawn from a broader area in the 1977 AHS than in the 1984 survey.

To be specific, the 1984 tenant survey selected control households from six municipalities contiguous to Los Angeles that do not apply any form of rent control: Long Beach, Pasadena, Torrance, Glendale, Inglewood and Burbank. These six cities contain about 29 percent of the total number of renters who live outside the City of Los Angeles, but within the local Standard Metropolitan Statistical Area.² By contrast, the AHS data encompasses the entire SMSA, but do not identify the resident jurisdictions of the households in the sample other than those residing in Los Angeles and Long Beach. As a result, control households in the 1977 sample may have resided in Long Beach or anywhere within the suburban ring, including but not limited to the six cities from which the 1984 control households were drawn.

To ensure that the types of housing units included in the analysis were representative of the units subject to rent stabilization in Los Angeles, each sample excluded single-family units³ and units in subsidized housing. In addition, the 1977 sample was adjusted to exclude units renting for more than the "luxury cut-offs" established by the 1979 Los Angeles rent stabilization Ordinance, which exempted these relatively high-rent units from the stabilization program.⁴ The 1984 sample excluded units in buildings constructed after 1978, which are exempted under the Ordinance, and Los Angeles renters who reported that their units were exempt from stabilization.

The survey process necessary to make this adjustment yielded the first finding of major importance revealed in the course of the study: more than two out of five tenants in the City of Los Angeles reported that they did not know whether or not their dwellings are subject to rent stabilization. The precise fraction was 41% of all tenants. Despite all of the policy debate and resulting press attention to the issue that has occurred over the past six years, it seems that a very substantial share of the Los Angeles renter population has not been moved to learn whether there is a legal ceiling on the rents that they can be charged. This level of tenant unawareness may in itself have public policy implications.

Because there is often a correlation between higher incomes and greater awareness of public policy and law applicable to the survey respondent, households that reported uncertainty as to whether they were subject to stabilization were excluded from the 1984 sample only if they lived in single-family units or if their units rented for more than \$2,500 per month. The latter approximates the "luxury cutoff" rental for a four-bedroom unit that was stated in the Ordinance, but inflated to the value expressed in 1984 dollars.

Exhibit 2-1 summarizes the characteristics of the samples used in the tenant analysis. The 1977 data base contains information on a total of 4,388 renters, 2,351 in the City of Los Angeles and 2,037 in surrounding areas. The 1984 sample includes 2,299 renters in Los Angeles and 404 in contiguous, unstabilized cities.⁵ Sampled households outside the City tend to have higher incomes and are less likely to be headed by members of minority groups and elderly persons. These patterns are evident in both samples, although the differences in age are relatively small in 1984. Finally, the units inside the City tend to be a bit smaller in terms of number of rooms than those outside, but the buildings in the City sample tend to contain more units.

In order to improve the comparability of the Los Angeles and non-Los Angeles samples, we defined a total of 18 household types for 1977 and 28 types for 1984, based on the joint distribution

EXHIBIT 2-1

THE 1977 AND 1984 TENANT SAMPLES

	1977		1984	
	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>
Number of Households	2,351	2,037	2,299	404
Household Income (%)				
< \$5,000	23	20	2	1
\$ 5,000- 9,999	29	26	12	12
\$10,000-19,999	34	38	33	25
\$20,000-29,999	9	10	21	28
\$30,000-39,999	4	3	8	10
\$40,000+	2	2	24	24
	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
Average Income	\$11,741	\$12,459	\$23,634	\$25,234
Race of Head (%)				
White	59	68	53	65
Black	14	8	19	13
Hispanic	20	19	18	12
Other	7	5	8	7
	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
Age of Head (%)				
Under 30	33	39	25	26
30-61	47	43	59	56
62+	20	18	16	19
	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
Average Age	42	41	42	42

of the reported incomes and races of the respondents. We then constructed a set of statistical weights for each survey year which made the distribution of control households by income and race identical to the distribution observed in the Los Angeles sample. In the analysis that follows, all data for households outside of the City of Los Angeles have been weighted in this manner. While this should increase the comparability between the control households and those in the City, comparisons between such households must recognize that the underlying samples may remain somewhat different across locations and over time.

2.2 A Comparison of Trends in the Housing Situation of Renters: 1977-1984

Despite this important caveat, some basic insights on the impact of rent stabilization can be gained by comparing broad trends in the cost and quality of housing inside and outside of the City during the periods before and after enactment of the stabilization program. This section begins by examining changes in average rents and rent-to-income ratios between 1977 and 1984. It then examines trends in other factors that arguably might be affected by rent control, including household mobility, the physical condition of the housing stock, and the ratio between numbers of occupants and numbers of rooms in the housing unit where they live.

2.2.1 Trends in Rents and Rent-to-Income Ratios

Analysis of these trends requires that the payments that all tenants make for habitable shelter be converted into a standard basis of comparison despite the fact that some landlords provide utilities within the rental charge and others do not.⁶ Most tenants who do not pay for their own utilities have no occasion to know what portion of their rent payment is traceable to reimbursement of the landlord for payment of utility bills. However, tenants in both samples who paid their own utilities did furnish data on the monthly costs of these utilities. Thus, by adding their utility costs to their rent payments, it was possible to

convert their monthly expenditures for habitable shelter into figures comparable to the rent payments made by households in buildings where utilities were included in the rent. This Report refers to the figure that includes both rent and utilities⁷ as "gross rent." The term "contract rent," refers only to those payments made directly to the landlord, which sometimes do but usually do not include a component to defray utility costs.

Exhibit 2-2 presents information on average gross rents in each of the survey years. The Exhibit also presents information on the changes that occurred in average gross rent-to-income ratios over the seven-year period, as well as shifts in the distribution of these ratios.⁸ Differences between 1977 and 1984 averages that are shown to be significant by standard statistical tests are identified by asterisks.

The first major finding presented by the Exhibit is that over the period between the surveys average gross rents in rent stabilized units within the City of Los Angeles rose by a total of 116% -- or an average of about 10.9 % per year⁹ -- from \$205 per month in 1977 to \$444 in 1984. This increase was slightly smaller than the average increase that occurred in non-stabilized units in surrounding areas, where average gross rent rose by a total of 120%, from \$213 per month to \$469. This works out to an average growth of about 11.1% per year. Although the units sampled outside the City were always a bit more expensive on the average than those inside, the data indicate that the rate of growth in average rents between 1977 and 1984 differed by only about two-tenths of one percent of gross rent per year in the jurisdiction that has chosen to enact rent stabilization. This difference is too small to permit confident judgment as to how much of it may reflect rent stabilization and how much reflects other economic and other factors that distinguish Los Angeles from contiguous cities.

The reader should bear in mind that these figures refer to average rents and rent increases. The situations of individual units and households may differ greatly within the City and between the City and the surrounding areas. Thus, the fact that

EXHIBIT 2-2

TRENDS IN RENTS AND RENT-TO-INCOME RATIOS: 1977-1984

	<u>Inside Los Angeles</u>		<u>Outside Los Angeles</u>	
	<u>1977</u>	<u>1984</u>	<u>1977</u>	<u>1984</u>
Average Contract Rents	\$189 ***	\$408 ***	\$193 ***	\$422 ***
Average Gross Rents	\$205 ***	\$444 ***	\$213 ***	\$469 ***
Average Gross Rent-to- Income Ratio	26.9% ***	28.5% ***	27.5% **	29.7% **
Distribution of Households by Rent-to-Income Ratios				
< 0.20	39.7% ***	35.2% ***	40.3% **	33.8% **
.20 - .30	26.6%	27.3%	24.8%	24.0%
.30 - .40	15.8% *	17.5% *	15.7%	17.2%
.40+	17.9% *	19.9% *	19.3% **	25.0% **

*** The difference between the 1984 and 1977 ratios is statistically significant at the 99% level of confidence.

** The difference is statistically significant at the 95% confidence level.

* The difference is statistically significant at the 90% confidence level.

average gross rents have risen at roughly the same rate inside Los Angeles and in surrounding unstabilized jurisdictions does not mean that rent stabilization has had no effect on City renters. Stabilization applies only to units that are not vacated and to tenants who do not move. Rents on vacated units can be raised by any amount. Because the City's rent stabilization program has since 1979 capped annual increases in the contract rents charged to tenants who do not move at a maximum well below the average rate of increase that the data show actually occurred in the stabilized housing stock, it is clear that the experience of City tenants who moved has been very different from those who did not, and probably also quite different from counterpart movers and non-movers in unstabilized areas. It is only when the experience of City tenants who moved is averaged against that of tenants who stayed put that the rent trend line in the City becomes nearly identical to the trend line in unstabilized areas.

The second major finding presented in Exhibit 2-2 is that both inside and outside the City average gross rents rose faster than average tenant income between 1977 and 1984, so that rent absorbed a larger share of household earnings at the end of that period than at the beginning, but this trend was less pronounced in the City than in the unstabilized areas. Current Federal housing programs treat "affordable housing" as housing that costs no more than 30% of household income.¹⁰ The proportion of City rent stabilized households spending a larger share than that for housing rose from 33.7% to 37.4% over the period, while in the non-stabilized areas this segment of the renting population grew from 35.0% to 42.2%.¹¹ At the other end of the scale, the proportion of households spending less than 20% of their income for housing dropped noticeably both inside and outside the City.

Whether the Federal 30% standard is in fact a reasonable definer of housing affordability has been the subject of some controversy in recent years. Some sentiment has favored a 40% standard. The data indicate that even according to this standard one in every four households living in non-stabilized rental units in the cities contiguous to Los Angeles occupies housing

that it cannot afford, and that one in every five rent-stabilized households is in the same position. And, in both areas this proportion has grown significantly over time.

Turning to the distribution of trends in gross rents and rent-to-income ratios since 1977 among demographic groups in the City's rent-stabilized population, it quickly becomes clear that some have experienced more of the general deterioration in housing affordability than others. Our major findings in this regard are shown in Exhibit 2-3, which displays trends in gross rents and gross rent-to-income ratios for groups of tenant households in the City defined by age of household head, household size, income, race, and length of tenure.¹² This breakdown, which is highlighted below, shows that the largest average percentage increases in the share of income consumed by housing costs were experienced by:

- * Hispanic, Asian and Native American households.
- * Households with five or more members.
- * Households that have been in their current units for not less than one nor more than five years.
- * Households with incomes of \$10,000 to \$30,000 per year.

Members of each of these groups averaged the largest increase in the size of the share of their incomes represented by the cost of their rental housing, as against other members of each group.

On the other hand, the smallest average percentage increases in rent-to-income ratios (some of which did not rise at all, on the average) were experienced by:

- * Households that have occupied the same units for at least six years.
- * Single-member households.
- * Elderly households.
- * White households.

The data indicate that the average ratio of gross rents-to-income of the first three of these groups declined between 1977 and 1984, though statistical tests confirm only the fall in the ratio

EXHIBIT 2-3

TRENDS IN RENTS AND RENT-TO-INCOME RATIOS IN LOS ANGELES BY HOUSEHOLD TYPE: 1977-84

	Gross Rents		Gross Rent-To-Income Ratio	
	1977	1984	1977 (%)	1984 (%)
<u>Age of Head</u>				
Under 30	\$207	\$460	26.7% ***	30.1% ***
30-61	\$209	\$447	24.0% ***	26.7% ***
62+	\$194	\$379	34.1%	33.4%
<u>Household Size</u>				
One	\$185	\$384	29.4%	28.4%
Two	\$228	\$485	25.0% ***	27.2% ***
3-4	\$213	\$485	25.8% ***	29.0% ***
5+	\$201	\$434	21.3% ***	32.1% ***
<u>Income</u>				
< \$10,000	\$172	\$393	37.3% ***	51.9% ***
\$10-20,000	\$221	\$405	19.7% ***	37.0% ***
\$20-30,000	\$262	\$448	13.3% ***	24.5% ***
\$30-40,000	\$306	\$507	11.1% ***	18.8% ***
\$40,000+	\$346	\$563	08.9% ***	15.3% ***
<u>Race</u>				
White	\$229	\$489	27.9%	27.9%
Black	\$168	\$402	29.2%	30.2%
Hispanic	\$168	\$371	24.1% ***	29.1% ***
Other	\$190	\$453	21.7% ***	27.2% ***
<u>Length of Tenure</u>				
Recent Movers	\$212	\$496	27.2% *	28.7% *
1-2 years in unit	\$207	\$495	26.8% ***	30.6% ***
3-5 years in unit	\$205	\$440	24.7% **	27.2% **
6+ years in unit	\$189	\$371	28.5% *	26.7% *

*** Differences between 1977 and 1984 ratios are statistically significant at the 99% confidence level.

** Differences are significant at the 95% confidence level.

* Differences are significant at the 90% confidence level.

for non-moving households as very probable; the drop in the ratios for single-member and elderly households could be illusory, but even if these ratios were stable that would distinguish these groups from virtually all others. The ratios for white households were identical in the two years.

The reader should note with respect to elderly households that, although their rent-to-income ratios did not increase, they paid among the highest proportions of their income for rent both in 1977 and in 1984. The effect of events and circumstances during the seven-year period was to bring the ratios of other groups up toward that of elderly households, but usually not far enough to equal the income share that older Los Angeles renters paid for shelter.

It must also be emphasized that all groups experienced growth in their average gross rents over the period, and that the dollar amounts of these average increases were often larger for groups that are not listed above as most or least affected in percentage terms. By definition, percentage change depends on how high a base one starts from. As will be seen later in this Chapter, if the question asked is which groups paid or did not pay the largest number of gross rent dollars between 1977 and 1984, different answers emerge. But to the extent that policy focus is on the proportion of income spent for rent, the groups identified stood out from the rest.

Breakdowns of rents and rent-to-income ratios for demographic groups in unstabilized areas outside the City are not presented here because sample sizes for some groups were small. In general, however, the same trends seemed to prevail both inside and outside the City. Problems of housing affordability increased most in large households and lower income households. The only notable difference between the City and surrounding jurisdictions was that long-term tenancy appears to have provided greater insulation from rent increases inside the City.

The statistics presented above depict changes in the overall structure of gross rents in Los Angeles before and after the enactment of rent stabilization. However, in part because the 1977 average includes the experience of a number of households that have since moved out of the City, these data do not reveal the average rent increase that was experienced by just the tenants who resided in Los Angeles in 1984. Such information is available from the 1984 tenant survey, which asked households to specify their rent when they first moved into their unit. If the households had been in the unit for more than six years, the respondent was asked to state the rent that had been charged for the unit in 1978, the base year of rent stabilization.¹³ Some 75% of the Los Angeles tenants sampled in 1984 (excluding recent movers) provided answers to these questions.

The resulting data are presented in Exhibit 2-4, stratified by the length of tenure of the reporting households, and showing a comparison between actual reported experience since the household moved into the unit and a simulation of the maximum stabilized rent that seemingly could be charged for that unit in 1984 under the provisions of the rent stabilization Ordinance.¹⁴ Rents presented here refer only to payments that tenants make to their landlords, not the additional amounts that most of them pay for utilities. This payment to the landlord is what the rent stabilization Ordinance refers to as "contract rent" and it is the only figure to which the rent stabilization ceilings apply. The reader should also be aware that it was not technically possible to include within this simulation of maximum allowable rent the upward adjustments that the Ordinance permits for capital improvements or hardship exceptions. Therefore, the "allowable" figure shown is probably a bit understated. Also, there are always reasonable questions about the accuracy of the data that result when one asks respondents to report events they experienced years before.

Despite these difficulties, the Exhibit shows that reported average 1984 contract rents were near the possibly understated "allowable" level for tenants of all lengths of tenure, but for

EXHIBIT 2-4

REPORTED RENT INCREASES BY LENGTH OF TENURE

<u>Length of Tenure</u>	<u>Initial Rent</u>	<u>Current Rent</u>	<u>Maximum Allowable Rent</u>
1-2 years	\$ 417	\$ 455	\$ 460
3-5 years	\$ 306	\$ 390	\$ 400
6+ years	\$ 220	\$ 336	\$ 336
All (excluding recent movers)	\$ 320	\$ 397	\$ 403

no tenure class did the level exceed the "allowable" figure. Average contract rents were about 1.5% less than the estimated "allowable" maximum, and the average annual rent increase implied by the difference between 1984 rents and those at the time the household moved in ran close to the maximum permitted under the Ordinance. Some 22% of the respondents reported 1984 contract rents that were more than 10% above the estimated "allowable" maximum, while about 24% reported rents that were less than 90% of that maximum. This general pattern held true regardless of length of tenure. These findings should be reviewed in light of the possible understatement of the allowable maximum and the likely imperfections in the data for past years.

To get another angle on the evolution of rent payments to landlords, the 1984 survey also asked households a general question on the frequency with which their (contract) rents had increased and whether such increases had tended to be above, below, or equal to the maximum increase permitted by the Ordinance. The responses of all respondents who gave substantive answers to these questions are presented in Exhibit 2-5. Once again, recent movers have been excluded, along with those who responded that they did not know or were not sure, a group that comprised about half of all respondents.¹⁵

The majority of respondents whose answers are summarized in the Exhibit reported that they had received a rent increase each year. However, about 32% of the respondents who had lived in their units for one or two years reported that they had never had a rent increase. Conversely, only 4% of the households who had lived in their units for six or more years reported never having had a rent increase. A similarly small percentage of all tenure groups reported that their rent had been increased more than once a year.

As to the amount of the increase, of those who indicated that they knew what the ceiling was, nearly 83% in all tenure groups reported that their rent increases had always been as high as the ceiling would permit. The remaining 17% were about evenly split between those who said that their rent had been raised more

EXHIBIT 2-5

REPORTED FREQUENCY AND AMOUNT OF RENT INCREASES

	<u>Length of Tenure</u>		
	<u>1-2 Years</u>	<u>3-5 Years</u>	<u>6+ Years</u>
<u>Frequency of Rent Increase</u>			
Never had an increase	32%	13%	4%
One each year	51%	63%	69%
More than one per year	3%	4%	4%
Less than one per year	<u>14%</u>	<u>20%</u>	<u>23%</u>
	100%	100%	100%
<u>Amount of Rent Increase¹</u>			
More than the maximum	5%	6%	5%
Always the maximum	79%	80%	82%
Less than maximum	6%	6%	4%
Sometimes more/sometimes less	7%	5%	5%
Don't know maximum	<u>5%</u>	<u>3%</u>	<u>4%</u>
	100%	100%	100%

1. Excludes households that have never had a rent increase.

than the lawful maximum, those who reported increases of less than the lawful maximum and those who said that they had had both experiences at different points in time. A small but reasonably consistent contingent in each tenure group said that they did not know what the maximum was.

Thus, the 1984 survey data indicate that most tenants now resident in Los Angeles who feel equipped to respond to questions of this kind believe that their rents are increased every year to the maximum extent the Ordinance allows. The survey also asked respondents what role special fees charged by the landlord and/or capital improvement surcharges had played in the increases they had experienced. Again excluding recent movers, 9% of the survey respondents indicated that their landlords had levied special fees for services provided. About 9% (though not necessarily the same 9%) of all respondents indicated that they had received a capital improvement surcharge. Most (82%) of the households that reported such surcharges were unable to provide the exact amount of the surcharge, but among the minority that did report an amount, the average surcharge was about \$21, or about 6% of the rent they paid to the landlord.

2.2.2 Other Changes in the Housing Situation of Area Residents

The previous section described overall changes in the level and structure of rents since the enactment of rent stabilization in Los Angeles. This section examines other changes in the housing situation of area tenants. We begin by examining changes in household mobility rates (i.e. the frequency of tenant turnover) before and after rents began to be stabilized. We then review changes in the incidence of more than one person per room in a rental unit. Finally, we report households' perceptions about the quality of their neighborhoods and dwelling units. Although comparable data are not always available on these questions from the 1977 survey, comparisons over time are made whenever possible.

Changes in Mobility Rates. The first major finding of the study with respect to tenant mobility is that it has declined significantly in recent years in the Los Angeles area, both inside and outside the boundaries of the City. This is shown in Exhibit 2-6, which compares the average length of tenure in 1977 with that in 1984, as well as the respective distributions of households in terms of the average number of years that they have lived in their current units.

The Exhibit shows that in the City of Los Angeles the average length of tenure increased over the period by almost two years, and the number of long-term tenants (defined as those who had been in their units for six or more years) nearly doubled, from 18% to 34%. At the same time, the proportion of households that had been in their units for less than one year declined sharply, from 31% to 21%. Similar phenomena were reported in cities contiguous to Los Angeles and, indeed, throughout the metropolitan area. All available data indicate that area renters, whether resident in the City or not, are considerably less mobile than they were in the recent past. Because this decline in movement is so general, there is no basis in the data for attributing the City's sharing in it to enactment of rent stabilization.

Exhibit 2-7 breaks down mobility trends among the Los Angeles rent-stabilized households according to income, race, household size and the age of the household head. The mean length of tenure is shown for each subdivision of each group, along with the percentage of each that consisted of recent movers, on the one hand, and households that have never moved during the rent stabilization era, on the other. The Exhibit shows that, although the mobility of every subgroup declined between 1977 and 1984, elderly and very low income households tended to be the least mobile, and lower income households, racial minorities, large families, and elderly households all registered above average declines in mobility. Although not presented here in detail, comparable trends were again observed in surrounding, unstabilized areas.

EXHIBIT 2-6

TRENDS IN MOBILITY RATES: 1977 - 1984

	Inside Los Angeles		Outside Los Angeles	
	1977	1984	1977	1984
Average Number of Years	3.56 yrs.***	5.49 yrs.***	2.91 yrs.***	4.44 yrs.***
Distribution by Length of Tenure:				
< One Year	31.2% ***	21.4% ***	33.9% ***	24.0% ***
1-2 Years	35.6% ***	23.5% ***	37.6% ***	29.1% ***
3-5 Years	15.6% ***	21.0% ***	14.7% ***	24.0% ***
6+ Years	17.7% ***	34.1% ***	13.8% ***	22.9% ***

*** Difference from 1977 to 1984 is statistically significant at the 99% confidence level.

EXHIBIT 2-7

TRENDS IN MOBILITY BY HOUSEHOLD TYPE:
1977-1984 (LOS ANGELES ONLY)

	Mean Length of Tenure		Percent Recent Movers		Percent 6+ Years	
	1977 (Years)	1984 (Years)	1977 (%)	1984 (%)	1977 (%)	1984 (%)
<u>Income Class</u>						
< \$10,000	3.8***	6.2***	31.6% ***	18.1% ***	20.3% ***	37.1% ***
\$10-20,000	3.3***	5.6***	31.0% ***	21.3% ***	14.5% ***	33.2% ***
\$20-30,000	3.5***	4.6***	28.0% *	21.1% *	16.8% ***	29.5% ***
\$30-40,000	3.7**	5.1**	29.4% *	21.4% *	18.8% *	28.6% *
\$40,000 +	2.2***	4.7***	41.5% **	25.3% **	4.9% ***	31.5% ***
<u>Race</u>						
White	4.0***	5.9***	28.9% ***	21.7% ***	20.9% ***	36.5% ***
Black	3.3***	5.4***	34.2% ***	20.1% ***	16.8% ***	32.3% ***
Hispanic	2.7***	5.1***	34.4% ***	21.1% ***	11.6% ***	31.3% ***
Other	2.6**	3.8**	34.6% *	25.6% *	9.4% ***	24.4% ***
<u>Household Size</u>						
One	4.2***	6.5***	28.4% ***	19.6% ***	23.3% ***	41.4% ***
Two	3.2***	5.3***	37.0% ***	23.1% ***	15.7% ***	33.4% ***
3-4	2.7***	4.3***	28.7% **	23.2% **	9.1% ***	24.3% ***
5 +	2.8***	5.6***	30.0% ***	16.2% ***	11.7% ***	34.7% ***
<u>Age of Head</u>						
Under 30	1.4***	2.5***	48.4% ***	39.0% ***	2.0% ***	8.8% ***
31-61	3.4***	5.2***	26.9% ***	18.0% ***	16.8% ***	34.3% ***
62 +	7.7***	10.4***	12.6% ***	6.2% ***	46.1% ***	66.8% ***

*** Difference between the 1984 and 1977 figures is statistically significant at the 99% confidence level.

** Difference is statistically significant at the 95% confidence level.

* Difference is statistically significant at the 90% confidence level.

In the 1984 survey, an attempt was made to identify some of the principal causes of changes in tenant mobility. Respondents were asked to name the main factors that might discourage them from moving to a different rental unit. Possible discouraging factors included a shortage of vacant units, scarcity of available units that the respondent felt he/she could afford, scarcity of units of adequate size, concerns about safety and neighborhood quality, worries about the cost of moving, and the desire to buy a home rather than move to another rented property.

The major finding that emerged from the responses to this question was quite clear: the affordability of available rental units was far and away the most commonly cited impediment to moving. This factor was listed by 61% of the respondents inside the City of Los Angeles and 58% of those outside. No other factor was identified by more than 10% of the respondents in either location. Since no comparable data are available for 1977 or any other prior year, we cannot report whether this view of affordability as a reason to stay put has strengthened or weakened since the advent of rent stabilization in Los Angeles. But there seems to be no question of its primacy in 1984.

Other Attributes of Housing. Exhibit 2-8 presents information on reported changes in the quality of rental housing in the Los Angeles area and in the quality of the neighborhoods where this housing is situated. In particular, it shows the incidence of crowding (defined as more than one person per room¹⁶), the incidence of need for repair of physical aspects of the unit or the building in which it is located, and tenant perceptions of the quality of their neighborhoods and dwelling units. Neighborhood quality was measured by a household's overall rating of its neighborhood as a place to live (excellent, good, fair, or poor). As to physical deficiencies, units were classified as "perceived in need of repair" if they had incomplete plumbing facilities,¹⁷ inadequate heating equipment¹⁸, or three or more less serious defects commonly associated with undermaintenance.¹⁹ While such ratings are necessarily subjective, they provide rough evidence

EXHIBIT 2-8

TRENDS IN CROWDING, HOUSING QUALITY AND NEIGHBORHOOD RATINGS: 1977-1984

	Inside Los Angeles		Outside Los Angeles	
	1977	1984	1977	1984
Average Persons Per Room	.672***	.796***	.624***	.801***
Proportion Crowded	9.3% ***	15.8% ***	6.8% ***	16.5% ***
Proportion Perceived in Need of Repair	12.5% ***	15.6% ***	4.8% ***	15.9% ***
Incomplete Plumbing	1.4% ***	0.6% ***	0.7%	1.4%
Inadequate Heat	10.8%	10.0%	3.1% ***	10.2% ***
3 or More Minor Defects	1.6% ***	7.0% ***	1.3% ***	6.1% ***
Neighborhood Rating				
Excellent	14.9%	15.5%	19.6%	21.2%
Good	44.3% *	42.4% *	46.6% *	51.0% *
Fair	32.0%	31.8%	27.8% **	22.8 **
Poor	8.5% **	10.2% **	5.9%	4.9%

*** Differences between 1984 and 1977 figures are statistically significant at the 99% confidence level.

** Differences are statistically significant at the 95% confidence level.

* Differences are statistically significant at the 90% confidence level.

of the changes in housing quality since the enactment of rent stabilization in Los Angeles, as perceived from the perspective of tenants inside and outside the City.

The first major finding reported in the Exhibit is that population density in rental housing has increased dramatically both inside and outside the City. In 1977, about 9% of renters in the City of Los Angeles reported that their households contained more than one person per room in the unit where they lived; by 1984 that proportion had risen to nearly 16%. The corresponding figures for surrounding areas were 7% in 1977 and 17% in 1984.²⁰ The average number of persons per room also increased significantly. That average rose from 0.67 to 0.80 within the City, and from 0.62 to 0.80 in surrounding areas. The data leave little question that Los Angeles area residents are steadily raising the ratio between the number of household members and the number of rooms occupied by the household.

However, as with the decline in tenant mobility, the data provide no basis to relate the increase in population density to enactment of rent stabilization in Los Angeles. If anything, the data reported indicate that the density trend since that enactment has been more pronounced in contiguous areas than in the City, although the small size of the non-City sample should make one cautious about any such conclusion. If overcrowding has been a growing problem, by 1984 it had become a problem of approximately equal dimensions in rent-stabilized areas and adjoining non-stabilized areas. According to these data, stabilization neither caused it nor did it cure it.

The second important finding arising from the data reported in Exhibit 2-8 is that the reported incidence of units and/or buildings in need of repair also increased between 1977 and 1984 both inside and outside of the City. In 1977, about 12% of all units/buildings in Los Angeles were classified by their tenants as "perceived in need of repair;" by 1984, this proportion had increased to 16%. This increase was not caused by any rise in the

incidence of inadequate plumbing or heating, both of which showed declines over the period. Rather, it reflected growth in the proportion of units with three or more less serious deficiencies.

In non-stabilized areas outside the City, the direction of the trend was the same but the rate of physical deterioration seemed to be much greater and the increase in serious problems seemed to be much more prominent. The proportion of units/buildings reported to be in need of repair outside the City more than tripled between 1977 and 1984, from about 5% to about 16%. Part of this traced to an increase in the incidence of less serious deficiencies comparable to the one reported by City residents. But the factors that spurred the suburbs to a much higher rate of reported deterioration than the City's were a tripling in the proportion of units with inadequate heat and a doubling of the proportion of those with inadequate plumbing. Once again, and particularly given that one would normally expect such structural factors as heat and plumbing to hold relatively constant over time, the small size of the non-Los Angeles sample suggests caution about making too much of this apparent difference between areas.

Leaving aside whether this difference in the incidence of serious problems inside and outside the City is real, however, it may be significant that City tenants reported no increase in the most serious problems and that the rate of incidence of less serious ones grew at about the same rate in the Los Angeles rent-stabilized population as in the non-stabilized households in surrounding areas. This again suggests that the presence or absence of rent stabilization has not been a major factor in determining trends in rental housing maintenance. The data do indicate that declining maintenance is a problem, but it seems to be a problem common to both the City of Los Angeles and to unstabilized jurisdictions in its environs.

The final major finding reported in Exhibit 2-8 is that, unlike the behavior of other indicators of perceived housing quality, tenant household ratings of their neighborhoods remained fairly constant in the City throughout the period, and constant

to rising in surrounding areas. In 1977, about 59% of City residents rated their neighborhoods as "excellent" or "good;" in 1984, the figure was 58%. Neighborhood ratings were higher outside the City in both survey years, and the proportion of non-Los Angeles respondents who rated their neighborhoods as "excellent" or "good" increased from 67% to 72%. The same contrast occurred at the other end of the quality scale, with the proportion of City tenants rating their neighborhoods as "poor" rising a bit while the corresponding proportion of non-City residents shrank. In view of the fact that the non-City ratings were always substantially higher than those recorded in the City, and that the differences in trend were very modest, it does not appear that the enactment of rent stabilization had any discernible effect on tenant perceptions of neighborhood quality.

Exhibit 2-9 breaks down the 1984 survey returns on housing and neighborhood quality according to the income, the race, the size, and the length of tenure of the reporting household, along with the age of the household head. These data show a number of important things with respect to the distribution of perceived problems of quality.

First, the distinctive perceptions of very low income households were clearly etched. Households with incomes of \$10,000 or less stood out in both categories of housing problems and were the least satisfied of all income groups with the quality of their neighborhoods. Conversely, households with incomes of \$40,000 or more reported better neighborhood ratings and lower incidences of repair problems than did those in all other income groups. While these households had relatively low population densities per room, these densities were not as low as those reported by households with \$10,000 less in annual income.

Second, Hispanic households reported much the highest incidence of needs for physical repair, along with much higher population densities per room than those recorded by any other racial group, while white households reported the lowest incidence of repair problems, the lowest densities and the greatest degree of satisfaction with their neighborhoods. Hispanic households,

EXHIBIT 2-9

CROWDING, HOUSING QUALITY, AND NEIGHBORHOOD RATINGS BY HOUSEHOLD TYPE: 1984 (LOS ANGELES ONLY)

<u>Income Class</u>	<u>Average Number of Persons Per Room</u>	<u>Percent Crowded</u>	<u>Percent Perceived In Need of Repair</u>	<u>Percent Satisfied with Neighborhood</u>
< \$10,000	.936	20.9%	25.1%	48.2%
\$10-20,000	.795	15.9%	15.8%	52.2%
\$20-30,000	.732	12.9%	14.0%	64.6%
\$30-40,000	.619	6.0%	14.9%	62.7%
\$40,000	.669	8.3%	7.7%	65.6%
<u>Race</u>				
White	.596	5.5%	9.6%	62.3%
Black	.758	13.5%	19.1%	49.6%
Hispanic	1.356	44.2%	31.2%	57.7%
Other	.955	25.0%	12.7%	49.2%
<u>Household Size</u>				
One	.430	0.0%	12.9%	60.5%
Two	.667	5.2%	13.5%	61.2%
3-4	1.189	30.0%	18.5%	53.2%
5+	1.740	82.5%	27.4%	50.8%
<u>Age of Head</u>				
Under 30	.881	16.6%	17.0%	54.6%
31-61	.832	18.5%	16.9%	58.0%
62+	.557	5.9%	11.8%	60.4%
<u>Length of Tenure</u>				
< 1 year	.815	14.7%	15.2%	80.2%
1-2 years	.870	17.4%	15.8%	74.5%
3-5 years	.803	18.5%	17.2%	75.0%
6+ years	.699	12.3%	14.7%	73.6%

despite their perceptions of repair needs and their higher average population densities, were more satisfied with neighborhood quality than were members of other minority groups.

Third, households with five or more members reported a much higher incidence of need for physical repair of their units and/or buildings than did smaller households, and the large households were less satisfied with their neighborhoods than were smaller ones. It will also be noted that nearly 83% of the large households contained more than one member per room in the dwelling unit.

Finally, elderly households and those who had been resident in their units for six or more years were noticeably less crowded and perceived less need for physical repair than younger and/or more recently mobile households. There was, of course, a good deal of overlap between elderly and long tenure households. Elderly households also ranked their neighborhoods relatively high, although long-term tenants as a group were the least satisfied with the quality of their neighborhoods.

The 1984 tenant survey asked additional questions of tenants inside and outside the City with respect to their current levels of satisfaction with seven specific aspects of their housing and location. These were unit size, unit condition, building upkeep, the distance that must be traveled from home to work, the amount of rent charged, the landlord, and the building manager. The responses of those who answered these questions are summarized in Exhibit 2-10. The term "satisfied" refers to those households who reported that they were either "very satisfied" or "somewhat satisfied" regarding each item.²¹ Among those who said they were satisfied, both inside and outside the City, there were a few more who answered "somewhat satisfied" than responded "very satisfied" in all instances save one. The exception was the level of satisfaction with the distance that must be traveled to work. In that case tenants inside the City -- but not those in surrounding areas -- recorded a markedly higher "very satisfied" than "somewhat satisfied" reading. Yet, when the "verys" and the

EXHIBIT 2-10

PERCENT SATISFIED WITH CURRENT HOUSING: 1984

	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>
Size of Apartment	86%	85%
Physical Condition	79%	80%
Overall Upkeep	77%	77%
Distance to Work	89%*	91%*
Rent	74%	75%
Landlord/Owner	75%**	81%**
Manager	79%	79%
Speed of Repairs	70%	72%

** Difference is statistically significant at the 95% level of confidence.

* Difference is statistically significant at the 90% level of confidence.

"somewhats" were added together in the City and outside, the residents of contiguous cities produced a higher "satisfied" proportion as to commuting distance than did City tenants.

The first major finding that emerges from the Exhibit is that most tenants, inside and outside of the City, report that they are more satisfied than not with regard to all seven items. In no case did the satisfied majority fall below 70% of the respondents in either geographic area, and in most instances the majority was 75% or more. Within the relatively high level of general satisfaction that this suggests, it seemed clear that the things that tenants were most satisfied with were commuting distance and the size of their units, while they were least satisfied with the speed with which physical repairs were done. But at least three out of four expressed complete or relative satisfaction with all other circumstances mentioned, including rent, building management and ownership, overall upkeep and physical condition.

The second notable finding evident from Exhibit 2-10 is that there was very little difference in the levels of satisfaction expressed by rent-stabilized tenants in the City and tenants of non-stabilized properties in contiguous areas. The satisfaction readings track each other very closely on nearly every count, and are nearly identical with respect to the amount charged for rent. Only two items generated statistically significant differences: satisfaction with the landlord and with commuting distance. In the latter case, the difference was very small (91% vs. 89% satisfied). With regard to perceptions of the landlord, the difference was a bit larger (81% satisfied outside the City vs. 75% inside), but it still only distinguished between a majority of four out of five as against three out of four. The possibility that this modest difference in perception is traceable to the fact that one group's rent was officially stabilized and the other's was not is reduced by the fact that the two groups were about equally satisfied with their rent levels, the management of their buildings and all measures of effective building mainte-

nance. The tenant satisfaction readings received did not suggest that the presence or absence of rent stabilization made a major difference in prevailing attitudes.

Exhibit 2-11 presents the same data on satisfaction levels inside and outside the City, but responses are stratified by the household's length of tenure. It shows that for most factors that are subject to change over time the level of satisfaction in both areas tended to decline the longer the household stays in the unit. However, this was not the case with respect to the satisfaction of rent-stabilized City tenants with the amount charged for rent. Here, satisfaction increased with length of tenure, which it did not among non-stabilized tenants in contiguous areas. It seems reasonable to conclude that the distinctive pattern inside Los Angeles is related to the tenure-based benefits that are features of the City's rent stabilization program. Nevertheless, it must be stressed that all differences in satisfaction levels occurred within a fairly narrow band of variation, as evidenced by the fact that two-thirds or more of the members of all tenure subgroups in the City reported relative satisfaction with their rents.

2.2.3 General Directions of Change

It is much clearer from the data that problems of housing cost and quality are increasing in the greater Los Angeles area than that the increase is related to the presence or absence of rent stabilization as it is now practiced within the City. Average rents are rising, but at only a slightly slower rate in stabilized as against unstabilized sectors. The same is true of average rent-to-income ratios. Tenants are moving less often than in prior decades, but the decline is no more pronounced if rents are or are not stabilized. Average population density per unit is rising everywhere surveyed, while most measures of housing quality suggest general deterioration, whether or not rents have been stabilized. In the Los Angeles area, as available data

EXHIBIT 2-11

HOUSING SATISFACTION BY LENGTH OF TENURE: 1984

	Length of Tenure			
	<1 Years	1-2 Years	3-5 Years	6+ Years
<u>Los Angeles</u>				
Size of Apartment	87%	85%	84%	88%
Physical Condition	85%	80%	79%	75%
Overall Upkeep	83%	78%	77%	73%
Distance to Work	86%	87%	92%	91%
Rent	69%	65%	77%	82%
Landlord/Owner	84%	77%	79%	77%
Manager	85%	79%	82%	74%
Speed of Repairs	76%	69%	69%	67%
<u>Outside Los Angeles</u>				
Size of Apartment	89%	82%	77%	93%
Physical Condition	92%	79%	71%	79%
Overall Upkeep	89%	72%	75%	70%
Distance to Work	92%	88%	92%	96%
Rent	80%	69%	76%	79%
Landlord/Owner	89%	78%	79%	76%
Manager	84%	85%	78%	73%
Speed of Repairs	89%	71%	70%	67%

indicate is also true in the rest of urban America, housing is becoming less affordable by historical standards and that fact is affecting many aspects of household budgets and behavior.

By and large, on the other hand, the data indicated that neighborhoods in the Los Angeles area are generally perceived to be holding their own in stabilized and unstabilized circumstances. Tenant attitudes toward neighborhood conditions are very largely positive and do not seem to vary at all with whether their rents are stabilized. The sole attitudinal pattern that distinguishes tenants of stabilized properties from those in non-stabilized ones is a tendency for people with longer tenure in stabilized units to be more satisfied with their rents than are households with shorter tenure.

These overall findings bear out the point stressed in Chapter 1: rent stabilization was not applied in a vacuum. Many powerful economic and social factors influence the behavior of rents, the cost of shelter relative to other goods and services, the incentives to build and maintain housing, and citizen attitudes toward their circumstances. The period between 1977 and 1984 was among the most turbulent in American history, as measured by fluctuations in such basic economic indicators as GNP growth, price inflation and interest rate change. Sorting out the effects of these upheavals from those of rent stabilization can only be done in general and probabilistic terms.

Nevertheless, the data do seem to show that rent stabilization has had important distributional effects. Although overall averages do not usually differ very significantly from those registered in unstabilized areas, it seems clear that some groups of tenants have benefitted more and others less from the program as administered thus far. Indeed, since the overall average rent charged and paid in stabilized areas is so close to that in unstabilized ones, it follows that there is no more than a modest flow of subsidy from all landlords of stabilized properties, taken together, to all tenants of those properties, taken as a whole. Rather, the overall subsidy effect of the form of rent stabilization enacted in Los Angeles seems to be to charge

higher rents for some units in order to permit lower rents to be charged for others. Put another way, some tenants pay rent premiums above what would be charged them if there were no stabilization so that other tenants may pay subsidized rents. We move now to an analysis of the financial dimensions of this cross-subsidization.

2.3 An Analysis of Monetizable Benefits

The previous section reviewed broad trends in the Los Angeles rental housing market since 1977. This section estimates the effects of rent stabilization that can be expressed in dollar terms. Of course, many types of costs and benefits cannot be satisfactorily or precisely measured in money. We will deal with some of these in the next section. Here, we are concerned with the measurable financial effects of stabilization and the distribution of these effects across various subsets of the rent-stabilized population.

We begin with a brief description of the methodology employed to estimate financial benefits and costs. We then present our estimates of the level of these financial effects and their distribution among types of City tenants.²² A more detailed discussion of the underlying methodology is presented in Appendix B.

2.3.1 What to Measure Reality Against?

The first challenge that faces any attempt to measure the financial effects of public policy is to determine what standard of alternative reality to measure against. What we know is what really happened; in this case, that rent stabilization was introduced in the City six years ago. What we cannot be absolutely certain about is what would have happened to rents if stabilization had not been enacted. There is no perfect measure of how the rental market would have behaved without stabilization. The best that the analyst can do is to find the most plausible mea-

asuring rods that arguably indicate what might have happened if rents had not been regulated, and then employ them with the understanding that none of them is likely to be accurate in every respect.

If possible, it is always better to use more than one such measuring rod. This acknowledges the fact that as good arguments may be made for one standard as for another. It also avoids the spurious accuracy suggested by a single benefit or cost estimate when others, based on other concepts of alternative reality, may have an equal technical basis for confident use. Ideally, one tries to employ standards that tend to bracket the plausible range of scenarios, i.e., one that tends toward one end of that spectrum and another that tends toward the other end.

For these reasons, we have used two different concepts of what would have happened to rents in the City of Los Angeles if stabilization had not been introduced, and thereby derived two sets of estimates of financial effects. In order to understand all that follows in this and later sections, the reader must have clearly in mind these two concepts and how they differ.

The first concept is that in the absence of rent stabilization rents in Los Angeles would have risen at the same rate as rents actually did rise in unstabilized areas contiguous to the City. This is not as simple a standard as it sounds. Housing outside the City is not necessarily identical in type to that inside, and may not have changed its characteristics in the same way over time. However, we used mathematical analysis to derive a rental housing inflation rate that controlled for such changes. In this Report we refer to the estimates of the rents that would have developed in Los Angeles without stabilization as "Imputed Rents." Put another way, whenever the term "Imputed Rents" is used, it means the rents that would have evolved in the City if Los Angeles rents had not been stabilized and had developed in the same way that rents for comparable units did in fact develop in adjoining, unstabilized areas.²³

The second concept used as a standard for comparison is that in the absence of rent stabilization rents in the City would have risen to the levels represented by the rents actually charged for the City units that have been vacated recently, permitting their owners to charge new tenants whatever rent they wished to set. Estimates based on this concept are referred to herein as "Market Rents." This label is not meant to suggest that these rents are necessarily the same as those that would have been tolerated by the market if stabilization had not been introduced. It is simply a term of convenience intended to denote the rents that Los Angeles landlords have actually charged for recently vacated (and thereby decontrolled) units in the City.

Within each concept of the rents that might have been charged if stabilization had never been enacted, we have estimated benefits and costs by subtracting the actual rent paid by the stabilized population from each of these conceptions of unstabilized rents. Note that this subtraction can yield a net cost as well as a net benefit from rent stabilization. If, for example, rents charged in the City to recent movers are actually higher under rent stabilization than the amounts being charged for similar units outside the City (i.e., if vacancy decontrolled rents are higher than Imputed Rents), then the financial effect on recent movers will register as negative, although the financial effects on other subsets of the population may be positive.

The Market Rent concept, on the other hand, is based on the assumption that landlords on average charge recent movers the same rents that would prevail in the absence of rent stabilization. As a result, recent movers, on average, show neither gains nor losses from rent stabilization when Market Rents are used as the standard of comparison.

On the average, the behavior of Imputed Rents and Market Rents has been fairly similar in the years since rent stabilization was introduced. Imputed Rents have risen by roughly 11.5% per year during that period, while Market Rents have risen by about 11%.²⁴ Once again, however, this is an average which may mask quite different experiences associated with particular indi-

viduals, groups or housing units. It is incorrect, therefore, to assume either that both standards increase by a percentage in this range for any unit, or that the standards necessarily behave similarly with respect to that unit.

It is easily seen that, like all other measuring rods of what might have been, both the Imputed Rent and the Market Rent standards are imperfect bases for comparison. It is possible that rents in the areas around the City have been affected by perceptions that the stabilization policy might spread, so that the Imputed Rent standard may understate what would be charged if stabilization had never appeared. Conversely, vacancy decontrol may result in recent movers paying higher rents for vacated units inside the City than they would pay for the same housing if there were no stabilization program. If true, this would mean that the Market Rent standard might overstate the rents that would be charged if there had been no stabilization. The behavior of landlords who own rental property both inside and outside the City may have been affected by stabilization constraints in ways that affect the accuracy of both standards.

There is no absolutely reliable analytic way to sort out these possible distortions. However, using one standard that seems likely to err in the direction of overstatement and another that leans in the other direction is likely to result in a range of estimates that brackets the true financial effects. We believe that these two standards yield such a range of estimates. Even so, the reader is cautioned once again to remember that rental markets are complex phenomena influenced by a wealth of economic and social factors that extend far beyond rent stabilization. We believe that our estimates of the financial effects that have been associated with stabilization are as technically sound as the data base will permit, but it should not be assumed that the same effects would materialize if the same policy were applied in a very different future economic or social context.

2.3.2 Estimates of the Money Benefits and Costs to Tenants

By comparing the rents that tenants in the Los Angeles rent-stabilized population reported that they paid in 1984 with both standards of what rents they would have paid without rent stabilization, we have derived estimates of the net benefit or cost arising from the rent stabilization program. Exhibit 2-12 presents these estimates for all stabilized households taken together, and then for each tenure subgroup. The estimates are made in terms of the number of dollars paid to the landlord each month, whether or not this amount includes utilities.²⁵ The average household income and actual contract rent of each group are repeated from earlier Exhibits for easy reference. Figures preceded by minus signs indicate that rent stabilization has created a net monthly cost to that subgroup, on the average, as against the rent that they would pay if stabilization had not been enacted.

The first major finding that emerges from this Exhibit is that, consistent with our earlier finding that average rents have risen only slightly more slowly in the stabilized City areas than in surrounding unstabilized areas, by 1984 rent stabilization was achieving only modest dollar savings for all tenants taken together. Our estimates indicate that the range of overall tenant savings ran \$7-18 per month, depending upon which standard one uses to simulate what would have happened without rent stabilization. These savings represent something between three-tenths and nine-tenths of one percent of average tenant household income. As previously noted, this means that, considered on a per-household basis, the flow of subsidy between all landlords taken as a group and all tenants taken together is not very imposing.

The second principal finding that the Exhibit supports is that, within this modest flow of average overall subsidy, different tenure subgroups have fared very differently from a financial standpoint. Those who have not moved since the enactment of rent stabilization have realized substantial savings in rents regardless of which standard of comparison is used. In 1984 we

EXHIBIT 2-12

COSTS AND BENEFITS FROM RENT STABILIZATION BY LENGTH OF TENURE

	Estimated Monthly Savings		Average Monthly Income	Average Contract Rent
	Based on Imputed Rents	Based on Market Rents		
All Households	\$ 7	\$ 18	\$ 1970	\$ 408
Length of Tenure				
Recent Movers	-6	0	2101	463
1-2 Years	-28	-15	1935	457
3-5 Years	-3	11	1964	394
6 or More Years	47	55	1925	334

calculate that these savings ran \$47-55 per month on the average, or \$564-\$660 per year. This works out to about 2.4%-2.8% of household income, a particularly non-trivial share in view of the fact that the subgroup with the longest tenure is also the one with the lowest average income.

Put another way, the analysis indicates that if rent stabilization did not exist, the average contract rent paid by this longest-tenured subgroup of households would be 14%-16% higher than the rents they actually paid in 1984. Since the overall average subsidy to tenants as a whole is so modest, it follows that the bulk of this subsidy to the long-tenure subgroup must be financed by higher-than-market rents paid by other tenant subgroups.

The Exhibit shows this to be the case, with the lion's share of the burden being carried by tenants who had been in their units for not less than one nor more than three years. The average rents paid by recent movers did not stray much from the average in unstabilized areas, and whether the average rents paid by those with 3-5 years' tenure were higher or lower than they would be if there were no rent stabilization depends upon which of the two standards of comparison is used. But the analysis indicates that those in the 1-2 year tenure group paid some \$15-28 more per month (or \$180-\$336 per year) in rent than they would have been charged if there were no stabilization program. Since the households in this subgroup have incomes only slightly higher than those in the longest-tenured subgroup, this added cost was also a non-trivial share of their income.

These findings also suggest some trends in the "rent markup" (i.e., the increase in rent charged to a tenant that moves into a stabilized unit as compared with the last rental paid by the vacating tenant) within the city. While markups in 1984 appear to have been rather modest, the margin between either concept of unstabilized rents and the higher rents that households with one or two years of tenure actually pay suggests that those who moved in 1982-83 probably paid considerably higher markups. It must be remembered that these households moved into their units at the

tail end of a highly inflationary period, when allowable rent increases for stabilized units were considerably below the overall increase in the Consumer Price Index. In the first year of stabilization, the all-item CPI for the Los Angeles area was 6.9%, or about equal to the 7% ceiling on rent increases. However, the inflation rate rose to 9.4% in 1979, peaked at 15.8% in 1980, and was 10.5% in 1981. Inflation then began to abate, dropping to 8% in 1982, 1.5% in 1983 and 4.2% in 1984. Thus, the high markups paid by movers in 1982 and 1983, following the end of double digit inflation, may well reflect an effort by landlords to recoup their losses in previous years.

The distribution of rental rates among tenure subgroups reflects a basic shift in what are technically known as "tenure discounts" that has occurred in the last few years. In 1977, before rent stabilization, the relationship in Los Angeles between average rents and length of tenure (holding other factors constant) declined steadily over time as people who had remained in their units for longer periods paid a smaller and smaller percentage of the average rents charged to recent movers, and even those who had been resident for only 1-2 years received a noticeable discount. This sort of pattern is typical of most rental markets, and reflects a tendency on the part of landlords to charge in-place tenants less. By 1984, however, as Exhibit 2-13 shows, the discounts previously received by households who had lived in their units for one or two years had largely disappeared, while the markdowns for households with three or more years of tenure had increased slightly, and there had been a dramatic increase -- to more than 30% -- in the average rent discount enjoyed by households that had never been decontrolled as compared with rents charged recent movers.²⁶ Although it is not necessarily valid to attribute all of this shift in the discount pattern to rent stabilization, it is reasonable to conclude that the tenure-sensitive features of the form of rent stabilization practiced in Los Angeles contributed to this result.

EXHIBIT 2-13

SHIFTS IN TENURE DISCOUNTS: 1977 - 1984

	Percent Markdown From Recent Movers	
	<u>1977</u>	<u>1984</u>
1-2 years	- 4.2% ***	- 0.6%
3-5 years	- 8.5% ***	-11.8% ***
6+ years	-15.6% ***	-30.1% ***

*** Statistically significant at the 99% confidence level.

Since the financial effects of rent stabilization appear to be so closely linked to a household's length of tenure, it is useful to review the demographic composition of the various tenure subgroups. These data are presented in Exhibit 2-14, broken down by the age of the household head, household size, race/ethnicity of the head, household income, and the Labor Market Planning Area (LMPA) of residence. In addition to the type of income analysis presented earlier, this Exhibit breaks the data according to the "very low," "low," and "moderate" income groupings used by the United States Department of Housing and Urban Development (HUD), which are based on both income and household size.²⁷

The Exhibit shows that long-tenured tenants tend to include an above-average concentration of white, elderly, and single-person households. As to relative income, although the breakdown by income is not statistically significant, there is some tendency for long-tenured households to have a higher concentration of low- and moderate-income households than the proportions of these in two of the other three tenure subgroups, but not higher than the subgroup whose members have occupied their units for only one or two years. With respect to geographic location, about 50% of the long-tenured households live in LMPA #3, which is the largest Planning Area, and which also contains the largest proportion of the population as a whole.

By contrast, the subgroup that the analysis suggests is financing much of the rent subsidy to the long-tenured households -- that is, the group with only one or two years of tenure -- is disproportionately young, and contains proportionately more large households, as compared with the long-tenured group. However, the two groups are nearly identical in income composition on both the absolute and the HUD scales. They are also identical as to racial/ethnic composition with the important exception that the shorter-tenured subgroup contains a smaller percentage of whites and a larger percentage of members of minority groups other than black and Hispanic. The percentage shares in the two populations made up of black- and Hispanic-headed households are of precisely

EXHIBIT 2-14

**DEMOGRAPHIC CHARACTERISTICS BY LENGTH OF TENURE:
1984 (LOS ANGELES ONLY)**

	<u>Length of Tenure</u>			
	<u>< 1 Year</u>	<u>1-2 Years</u>	<u>3-5 Years</u>	<u>6+ Years</u>
Age of Head***				
< 30	44%	32%	22%	6%
31-62	51	63	62	60
62 +	5	6	16	34
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
<u>Mean Age</u>	35 years	36 years	42 years	52 years
Income				
< 10,000	12	13%	14%	16%
10-20,000	32	33	32	34
20-30,000	20	24	21	19
30-40,000	8	8	9	7
40 +	28	22	23	23
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
<u>Mean Income</u>	\$25,212	\$23,223	\$23,570	\$23,098
Household Size***				
One	33%	27%	36%	44%
Two	33	33	25	30
3-4	28	32	30	19
5 +	6	7	10	8
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
<u>Mean Size</u>	2.32	2.51	2.47	2.17
HUD Classification				
Very Low Income	20%	29%	25%	29%
Low Income	24	21	21	23
Moderate Income	19	22	22	19
Other	37	29	32	29
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
Race/Ethnicity***				
White	54%	53%	48%	58%
Black	19	19	24	19
Hispanic	18	17	22	17
Other	9	11	6	5
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
LMPA**				
1	3%	6%	6	6%
2	16	18	19	18
3	48	44	43	50
4	21	17	16	10
5	8	12	12	11
6	3	3	3	5
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

*** Differences are statistically significantly at the 99% confidence level.

** Differences are statistically significant at the 95% confidence level.

the same size. The demographic characteristics that largely distinguish the subsidizers from the subsidized are not their relative incomes nor their racial/ethnic composition; what distinguishes the subsidizing households appears to be their relative youth, their relatively large households and their residential mobility.

This is not to say that the low income members of both subgroups receive no money benefits from rent stabilization. When, as in Exhibit 2-15, we break down the financial effects by the same demographic groupings applied to all rent stabilized tenants taken as a whole, we see that, on the average, households with incomes lower than \$30,000 in 1984 did pay at least a somewhat lower monthly rental than they would have paid had there been no rent stabilization program. How much lower varied quite a lot according to whether one accepts Imputed Rents or Market Rents as the proper standard of comparison. Conversely, households with higher incomes paid higher average rents than they would otherwise have paid, and the size of the margin was about the same using either standard. Using the HUD income/household size classifications, only those with incomes above "moderate" (i.e., above \$34,560 for a family of four) averaged a net financial loss from rent stabilization.

As to family size, this analysis indicates that it was not the largest households that experienced a net cost from rent stabilization, but those with 3-4 members, which showed the only average deficit among these subgroups. Among racial/ethnic subgroups, whites most clearly benefitted financially, on the average, while the situation of households headed by blacks and Hispanics varied from no effect, as against Imputed Rents, to a relatively high subsidy as against Market Rents.

The demographic subgroups that were most clearly financially aided by rent stabilization are the elderly, those who live alone, those with very low incomes, and those who live in buildings containing no more than 12 units. Of course, these groups are heavily interrelated, since more than 67% of all elderly households have lived in their rental units for more than six

EXHIBIT 2-15

AVERAGE SAVINGS FROM RENT STABILIZATION BY HOUSEHOLD TYPE

	Estimated Monthly Savings		Average Contract Rent	Average Annual Income	Tenure Distribution
	Based on Imputed	Based on Market			% With 6+ Years Tenure
<hr/>					
Age of Head					
Under 30	-\$ 9	\$ 8	\$412	\$22,671	9%
30-61	6	14	405	25,932	34%
62 plus	49	60	352	16,766	67%
<hr/>					
Household Size					
One	25	45	357	21,916	41%
Two	0	3	442	27,627	33%
3-4	-12	-6	335	23,480	24%
Five plus	6	9	388	22,017	35%
<hr/>					
Race of Head					
White	12	14	444	25,705	36%
Black	-1	20	344	20,047	32%
Hispanic	-1	22	337	21,905	31%
Other ^a	20	29	412	26,402	24%
<hr/>					
Income					
Less Than \$10,000	28	65	308	5,629	37%
\$10,000-19,999	18	38	367	13,411	33%
\$20,000-29,999	13	16	402	22,156	30%
\$30,000-39,999	-16	-18	466	32,501	29%
\$40,000 plus	-30	-34	509	47,519	31%
<hr/>					
HUD Classification					
Very Low Income	26	55	334	7,931	36%
Low Income	4	24	374	15,827	34%
Moderate Income	24	27	399	22,653	30%
Other	-28	-33	501	44,340	31%
<hr/>					
Number of Units					
1-5	9	26	372	22,964	37%
6-11	17	31	386	24,758	34%
12 plus	2	6	432	24,406	33%
<hr/>					
Labor Market Planning Area					
1	59	73	319	23,259	39%
2	29	48	318	19,318	36%
3	-2	19	400	25,000	37%
4	29	17	449	24,444	24%
5	-66	-80	550	27,776	33%
6	52	49	371	22,594	45%

a. Sample sizes for this group were small, so results should be interpreted cautiously.

years, most elderly households are small and many have modest incomes. Particularly for the poorest among the households in any or all of these subgroups, rent stabilization has pretty clearly made a considerable financial difference. But it should not be assumed that all elderly households and/or those with low incomes shared in these benefits; one-third of all elderly households and two-thirds of all households with incomes of less than \$20,000 per year have been in their units for fewer than six years. At the other end of the income scale, about one-fourth of all households which have been in their units since stabilization began have incomes over \$40,000 per year. The fact that the financial benefits of rent stabilization tend on the average to track the length of a household's tenure in a unit means that, although benefits do flow to many elderly and low-income people, they do not systematically reach all of the old or all of the poor, while benefits are provided to some who are neither.

The situation is less clear with respect to the financial effects upon members of racial/ethnic minorities. As the Exhibit shows, whether black and Hispanic households were charged lower or higher average rents than they would have been without rent stabilization depends upon which standard of comparison one selects. If the standard is unstabilized rents in neighboring cities, neither blacks nor Hispanics, taken as a whole, received any subsidy. On the other hand, if the standard is the rents charged in the City for vacated units, then both groups averaged \$20-22 less per month in rent than they otherwise would have been charged. Meanwhile, Asian, Native American and other minority households appear to have benefitted from rent stabilization by either standard of measurement. However, the sample size for this latter group is very small, making the finding somewhat tentative.

The primary reason for the intermediate results registered by black and Hispanic households is that their tenure patterns fall largely between high and low mobility. That is, these households tend to have been in their units for at least one year, but not for more than five years. Since the financial

effects of rent stabilization are highly sensitive to length of tenure, this means that relatively few black and Hispanic households received the subsidies provided to those who had never moved since stabilization was enacted. Whereas a fair number of them paid the higher markups charged to households that moved in 1982-83, others among them received the net benefits provided to those who have been in their units for 4-5 years. No clearcut result emerges when one averages this experience and compares it with the two concepts of what rents would be without rent stabilization. What one concludes about the financial effects on racial/ethnic minorities as a whole depends, therefore, upon which of those two standards the reader believes is the better measure of what Los Angeles rents would be in an unstabilized market.

When one reviews the effects of rent stabilization on the demographic subgroups within each racial/ethnic grouping, further findings emerge. Exhibit 2-16 shows this breakdown. It demonstrates that, despite the unclarity of the net flow of subsidy to or from racial/ethnic minorities as a whole, the experience of some subgroups is reasonably clear. Specifically:

- * The only income subgroup of households headed by blacks which averaged a significant financial gain from rent stabilization was the group with an income of less than \$10,000 per year.
- * No income subgroup of Hispanic-headed households -- not even the very poorest -- averaged any financial gain if the standard of comparison is Imputed Rents (i.e., rents charged for similar units in contiguous unstabilized areas).
- * All income subgroups of members of minorities other than blacks and Hispanics realized substantial average financial benefits from rent stabilization, except for households with incomes of \$30,000 or more, which essentially broke even. (Again, however, the sample of members of these minority groups was small.)
- * White households with incomes under \$30,000 reaped net average benefits from rent stabilization. However, those in the upper income bracket experienced a significant net loss. Only single-member households benefited when white households were divided according to

EXHIBIT 2-16

AVERAGE BENEFITS FROM RENT STABILIZATION BY RACE AND INCOME

	Using Imputed Rent	Using Market Rent
White		
< \$10,000	\$43	\$72
\$10,000-20,000	\$39	\$52
\$20,000-30,000	\$21	\$20
\$30,000+	-\$33	-\$44
Black		
< \$10,000	\$15	\$60
\$10,000-20,000	-\$10	\$20
\$20,000-30,000	-\$ 4	\$ 6
\$30,000+	-\$15	-\$15
Hispanic		
< \$10,000	-	\$51
\$10,000-20,000	-\$ 8	\$17
\$20,000-30,000	-\$20	-\$ 7
\$30,000+	-\$19	\$ 5
Other		
< \$10,000	\$69	\$80
\$10,000-20,000	\$20	\$50
\$20,000-30,000	\$69	\$60
\$30,000+	-\$ 2	\$ 4

household size. White households of all larger sizes paid higher rents, on the average, than they would have if rent stabilization had never been enacted.

Again, these and the other effects on racial/ethnic subgroups that are reported in the Exhibit primarily tracked their tenure situations, not their income or other demographic characteristics.

Returning to analysis of the total flow of financial subsidy to all tenants taken together, we have characterized as modest the \$7-\$18 per month that the analysis suggests is the margin between what tenants in stabilized areas average in rent and what they would pay if rent stabilization had never been enacted. This characterization seems correct when expressed as average monthly savings per household. But there are about 489,000 stabilized units in the City. Because the stabilized sector is so large, the total number of dollars saved adds up to a considerable annual sum. To be precise, the data indicate that the total subsidy is in the range of \$41-\$106 million per year. (The lower figure uses Imputed Rents as a standard of comparison, the higher figure uses Market Rents.) We turn now to how this net subsidy is distributed within the stabilized population.

The first point to emphasize is that the figures above describe the net subsidy flow to tenants. As we have seen, not all tenants receive subsidy from rent stabilization; in fact, a substantial number pay higher rents than they would if stabilization were not practiced. The average stated above results when one subtracts these premiums above unstabilized rents from the total savings realized by the tenants who pay less in rent than they would without stabilization. Thus, the flow of subsidy to the tenants who are subsidized is much larger than the net flow to all tenants as a whole. The nature of the analytic procedure used makes it impossible to say exactly how many tenants were subsidized and how many paid premiums, or precisely how large the dollar flows were in either direction.²⁸ The overall net subsidy resulted, of course, because the underpayments outweighed the premiums by a relatively modest margin. But the modesty of that margin must not be allowed to obscure the fact that each of these

two types of tenants either received or paid out resources with a money value that is probably a great deal higher than is suggested by the figures that emerge when these receipts and expenditures are offset against each other.

Exhibit 2-17 breaks down net inflows and outflows by demographic subgroup.²⁹ Net outflows are denoted by minus signs. Again, these are averages for each subgroup, so that even if the subgroup as a whole shows a net subsidy or premium, some members of that subgroup were in the opposite situation.

The Exhibit shows that, from the standpoint of income, the prime beneficiaries of rent stabilization appear to be households with earnings of less than \$30,000 per year. The prime premium payers, on the other hand, are households that earn more than \$40,000 per year. In 1984 the former group received something in the range of \$136-\$179 million in net subsidy, while the latter paid out \$72-\$94 million in net premiums. Similar relations tended to characterize the elderly vs. those under age 30, single-member households vs. those with 3-4 members, and long-tenured households vs. those with 1-2 years' tenure. These are all of the same relationships that we have seen before, though now stated in net annual dollar flows.

And, again, the factor that primarily determines the size of the subsidy line on which a household falls is length of tenure in the unit. According to our estimates, about 166,000 renters (or about 34 percent of stabilized tenants) live in units that have never been decontrolled. In 1984, these households received an estimated aggregate savings of between \$79 million and \$113 million per year. By contrast, households that had been in their units for fewer than 3 years paid about \$40 million more than they would have without rent stabilization, accounting for about half of the total benefits received by the long-tenured residents. When benefits are based on the assumption that recent movers in the City are currently paying the rents that would be charged if there were no stabilization, subsidies and premium payments by households of other lengths of tenure largely cancel

EXHIBIT 2-17
 AGGREGATE ANNUAL BENEFITS OF RENT STABILIZATION
 BY HOUSEHOLD TYPE
 (in \$ millions per year)

	<u>Based on Imputed Rents</u>	<u>Based on Market Rents</u>
<u>Age of Head</u>		
Under 30	\$-10.0	\$10.1
30-61	16.0	46.4
62+	35.0	49.4
<u>Household Size</u>		
1	57.4	106.0
2	-.9	5.9
3-4	-18.5	-10.1
5+	2.9	4.0
<u>Race/Ethnicity</u>		
White	35.0	46.5
Black	-1.3	24.4
Hispanic	-.9	21.8
Others	8.2	13.1
<u>Income</u>		
< \$10,000	40.4	64.8
\$10-20,000	59.3	86.9
\$20-30,000	27.7	23.7
\$30-40,000	-12.7	-10.3
\$40,000 +	-73.7	-59.1
<u>HUD Definition</u>		
Very Low Income	72.6	101.7
Low Income	10.3	37.3
Moderate Income	52.6	39.5
Upper Income	-94.4	-72.5
<u>LMPA</u>		
1	20.6	25.1
2	32.7	52.9
3	-6.1	56.5
4	28.5	15.9
5	-46.8	-55.5
6	12.1	11.2
<u>Length of Tenure</u>		
< 1 Year	-6.2	0
1-2 Years	-33.4	-21.5
3-5 Years	3.4	14.3
6+ Years	79.4	113.2

out, so that net overall savings (\$106 million) are about the same as the estimated savings of long-tenured tenants (\$113 million).

2.3.3 Financial Benefits Perceived by Tenants

These estimates presented up to this point show what the analysis suggests are the actual financial effects of rent stabilization. The 1984 survey also collected information on what financial difference rent-stabilized tenants believe that stabilization makes. Respondents were asked to estimate what their units would rent for in the absence of rent control. It will be recalled that two out of five Los Angeles tenants surveyed did not know whether their units were covered by rent stabilization, so that it is not surprising that the fraction who responded similarly to this question was about the same. Of those who did respond to this question, about 68% provided a specific dollar amount and another 20% were able to indicate whether they thought that their rents would be higher, lower, or about the same.

The major overall finding of this research was that some 83% of these tenants believed that their rents would be higher without rent stabilization, 7% believed that they would be lower, and 10% believed they would be about the same. The proportion of households reporting that their rents would be higher without stabilization increased with length of tenure. However, even among recent movers, 71% of all respondents believed that their rents would be higher without rent stabilization. Clearly, among the tenants who answered this question, the program is generally perceived to be beneficial.

Exhibit 2-18 shows how much monetary difference these tenants think stabilization makes. The figures shown represent the dollars per month that members of each tenure subgroup estimated would be added to their rent if there were no stabilization program. To facilitate comparison, our earlier estimates of the actual net benefits/costs to each subgroup are also presented.

EXHIBIT 2-18

TENANT ESTIMATES OF MONETARY SAVINGS BY LENGTH OF TENURE

(Average Monthly Benefits)

	<u>Tenant Estimates</u>	<u>Estimates Based On Imputed Rents</u>	<u>Estimates Based On Market Rents</u>
Recent Movers	\$ 94	\$- 6	\$ 0
1-2 Years	116	-28	-15
3-5 Years	130	-3	11
6 + Years	<u>180</u>	<u>47</u>	<u>55</u>
All Households	135	7	18

The contrast between what is perceived and what the data suggest is real could hardly be more striking. Tenants who had been in their units for one or two years, who the analysis show to be paying average rents well beyond those that they would have paid if stabilization had not been enacted, estimated that they would be charged an average of \$116 more per month (an increase of about 25% above their current average rents) if the stabilization program did not exist. Recent movers and households with 3-5 years of tenure, who the analysis shows to be relatively unaffected by stabilization, thought they were benefitting to the tune of \$94-\$130 per month. Even households which had never moved since the advent of stabilization, who the analysis indicates were in fact benefitting most, generated an average savings estimate almost four times higher than the data indicate.

In dollar terms, if one totalled the tenant estimates of the money savings flowing to them from rent stabilization, the total net benefit to all tenants taken together would be about \$792 million a year, or between 7 and 20 times higher than our estimates suggest that they actually were in 1984. This occurs in part because very few tenants who responded to questions concerning the program's effects on them believed that stabilization could actually result in higher rent charges than they would experience if there were no such program. Since the analysis indicates that a very substantial number of tenants did in fact pay higher-than-unstabilized rents in that year, this perception is all the more remarkable.

This perception is probably closely associated with the aforementioned impression -- in Los Angeles and elsewhere -- that rent stabilization primarily generates a flow of subsidy from all landlords, taken together, to all tenants. In fact, as we have seen, by far the larger flows are within each group, and the resulting effects treat different subgroups very differently. This fact seems to be entirely unsuspected by the vast majority of the stabilized tenant population.

2.4 Non-Monetizable Benefits and Costs

Not everything perceived as a benefit or a cost of rent stabilization can be translated into dollars. This does not make these factors less important, it simply makes it impossible to lump them in with benefits and costs that can be monetized. This section deals with a number of the intangibles most frequently cited by tenants that fit into this non-monetizable category.

2.4.1 Security of Tenure

The term "security of tenure" means the relative degree of certainty of tenants that they can remain in their units if they choose. This certainty can be affected by many factors, including rent levels, special treatment of in-place tenants and the rules governing evictions.

Measuring security of tenure -- a highly subjective phenomenon -- is a difficult task. So is establishing its possible relation to rent stabilization. As noted earlier, household mobility rates did in fact decline in Los Angeles after rent stabilization was enacted, which meant that average length of tenure increased. However, the same trend occurred in surrounding, unstabilized areas, so that one cannot attribute the City trend to the introduction of stabilization. Thus, by this measure, it cannot be concluded that the program has increased tenure security beyond what would otherwise have occurred because of other influences upon economic and social behavior.

Another way to assess the effects of rent stabilization on security of tenure is to estimate the proportion of households that could not afford to rent their current units in the absence of stabilization. To do this, we calculated the rent-to-income ratios that would have resulted under each of the two concepts of unstabilized rents that we used in the analysis of monetizable benefits, that is, Imputed Rents and Market Rents. We then compared these ratios to the actual ones reported in order to see for how many households rent stabilization brought their current

housing into the "affordable range." Two standards of affordability were employed: 30% of income, the standard now used in most Federal housing programs, and 40% of income.

The results of this analysis are presented in Exhibit 2-19. The first two columns report the distribution of households by their current gross rent-to-income ratios;³⁰ the remaining columns present the distributions that would have resulted without rent stabilization according to each of the two different concepts of the rental market that would then exist. The total number of households that would fall into each category of ratios was then derived by the distribution in the survey sample to the total number of rent-stabilized households in the City and then rounding to the nearest thousand.

The major finding that can be drawn from the Exhibit is that, using the 30%-of-income criterion, a net figure of between 12,000 and 25,000 rent-stabilized households have housing costs that have been kept within the affordable range by rent stabilization. Applying the 40%-of-income criterion yields the same result because the same number of households is in the 30%-40% range regardless of whether rent stabilization or either concept of unstabilized rents is assumed. It should be borne in mind that these estimates of the number of households represent the net flow into the affordability range. That is, what they signify is that an estimated 12-25,000 more households have been moved into that range by rent stabilization than have been moved out of the affordability range by the same program. Also, as is evident from this and earlier Exhibits, a sizeable fraction of renters inside and outside of Los Angeles do in fact carry housing costs that do not show as affordable by either criterion.

Finally, in considering these figures, it is important to recognize that they are simply another way of looking at the financial effects of rent stabilization. They cannot be properly added to earlier estimates of monetizable benefits. Nevertheless, the data do suggest that by moderating rent increases for long-tenured residents, rent stabilization probably has resulted in keeping the housing costs of a non-trivial number of households

EXHIBIT 2-19

ESTIMATED DISTRIBUTION OF HOUSEHOLDS BY RENT-TO-INCOME RATIOS WITH AND WITHOUT RENT STABILIZATION

Actual Distribution		Distribution Based on Imputed Rents		Distribution Based on Market Rents	
Number of Units	Percent Distribution	Number of Units	Percent Distribution	Number of Units	Percent Distribution

Gross Rent-To Income Ratio

< .20	177,000	36%	170,000	35%	160,000	33%
.20-.30	140,000	29	135,000	28	132,000	27
.30-.40	81,000	17	81,000	17	81,000	17
.40+	91,000	19	104,000	21	116,000	24

within widely-accepted affordability standards. The survey indicates that in 1984 about 172,000 rent-stabilized households paid more than 30% of their income in rent. The analysis indicates that without rent stabilization this number would have increased by 7%-15%. This has doubtless contributed to their sense of security of tenure. It may also be that the already reported perception of tenants that rent stabilization is saving them a great deal of money had the same effect even if the measurable affordability of their housing did not change or changed in an unfavorable direction.

2.4.2 Tenant Perceptions of Non-Monetizable Benefits

The rent-stabilized tenants surveyed in 1984 were asked a series of structured and open-ended questions about the strengths and weaknesses that they perceived in the current program. They were asked to review a series of statements summarizing arguments often advanced in support or in criticism of rent regulation, and they were asked to state the pluses and minuses that ranked highest in their own minds. This section presents the results of this research.

Ten positive and negative statements about rent control were read to tenants in the survey in an order in which positives and negatives alternated. Respondents were asked whether the phenomenon referred to in each argument had happened to them, whether it had happened to a friend, whether they had heard about it happening, or whether they had no knowledge of it or were not sure. The answers received are shown in Exhibit 2-20.

Again, the reader will recall that 41% of all respondents said that they were unaware whether rent stabilization applied to them, so that it is unsurprising that many of them had no knowledge of the effects of the program. From 50% to 70% of the respondents to these questions always fell into the "No Knowledge" or "Not Sure/No Answer" categories. Most of the rest (28%-38% of all respondents) said they had heard about the phenomenon through the press media, but that it had not happened to them or to anyone of their acquaintance. The two arguments that

EXHIBIT 2-20

TENANTS' RESPONSE TO STRUCTURED QUESTIONS
ON EXPERIENCE WITH RENT STABILIZATION

	<u>Happened To Me</u>	<u>Happened To a Friend</u>	<u>Heard About It</u>	<u>No Knowledge</u>	<u>Not Sure/ No Answer</u>
Tenants have been able to stay in apartments that they would not have been able to afford if rents were not controlled.	7%	7%	37%	40%	10%
Buildings have become run down because rent controls give landlords no incentive to keep them up.	5%	4%	35%	44%	11%
People with large families can rent in buildings that would not let them in if there were no rent control law.	1%	3%	30%	54%	12%
By cutting down turnover of tenants, rent stabilization often locks minorities and other victims of discrimination into "ghettos."	1%	2%	28%	57%	13%
Rent stabilization keeps tenants from being unfairly evicted.	2%	5%	38%	42%	13%
Rent stabilization tends to make enemies of tenants and landlords, spoiling the good relations necessary for a happy, well-maintained building.	3%	3%	29%	54%	12%
Rent stabilization brings greater stability and security to neighborhoods.	3%	2%	34%	48%	14%
Rent stabilization keeps new rental housing from being constructed by removing the incentive to invest in it.	1%	2%	29%	55%	13%
Rent stabilization helps neighborhoods to keep a healthy mix of higher and lower income people.	2%	2%	30%	52%	14%
Rent stabilization encourages landlords to find ways around the law (e.g., evicting tenants in favor of a member of the landlord's family).	2%	5%	30%	50%	13%

they seemed to have heard about most were pro-stabilization: that the program keeps tenants from being unfairly evicted and that it allows tenants to rent apartments they could not otherwise afford. On the other hand, the three arguments that they seemed least familiar with were anti-stabilization: that it locks minorities into ghettos, that it makes enemies of tenants and landlords and that it discourages construction of new housing. However, the difference in the frequency with which respondents reported hearing of these phenomena were not great across the whole field of 10, and may not reflect significant distinctions in tenant attitudes.

Among the always small minority of respondents that reported personal or acquaintance experience with the phenomena cited in the arguments, making housing affordable through rent stabilization was clearly the one most frequently mentioned. A total of 14% of the respondents said either that they themselves had experienced this or that it had happened to a friend. The phenomenon mentioned second most often was the deterioration of buildings because stabilization discouraged good upkeep, with which 9% of the respondents cited such experience. None of the other phenomena seemed to have been items of personal experience for any appreciable number of respondents, though some did report indirect experience with eviction protection and landlord evasion of what they felt to be the intent of the Ordinance. Typically, the percentage of respondents reporting that a given phenomenon had happened to them was smaller than the proportion saying that it had happened to a friend.

Respondents were also asked to name the three most important benefits that they felt they received from rent stabilization, and then the three ways in which they felt that the program did them the most harm. Responses to these open-ended questions are summarized in Exhibit 2-21. The first column shows the proportion of respondents who named a given benefit (or harm) as the most important one. The second column shows the proportion of house-

EXHIBIT 2-21

PERCEIVED COSTS AND BENEFITS OF RENT STABILIZATION

	<u>% Listing as Most Important Benefit</u>	<u>Total % Listing as Benefit¹</u>
Rent Stability	32%	36%
Affordable Housing	7	10
Peace of Mind/Security	3	7
Safe from Eviction	2	6
Nice Neighborhood	<1	3
Good Maintenance	<1	3
Other Benefits	3	12
No Benefits	31	--
No Answer	23	--

	<u>% Listing as Most Important Harm</u>	<u>Total % Listing as Harm</u>
No Building Improvements	5%	6%
Annual Rent Increases	4	4
Seven Percent Standard Too High	2	2
Causes a Shortage of Rental Housing	<1	1
Causes Friction with Landlords	<1	1
Enables Landlords to Evict	<1	1
Increases the Number of New Tenants	<1	1
Other Harms	3	5
No Disbenefits	58	--
No Answer	26	--

1. Since respondents can list more than one benefit or harm, these totals do not sum to 100%.

holds that mentioned the particular benefit (or harm) at all. Only items mentioned by at least one percent of the respondents are listed in the Exhibit.

Once again, widespread tenant unawareness of rent stabilization probably affected these responses. About 31% of the respondents to these questions indicated that they did not benefit from rent stabilization, and another 23% did not provide any answer. Among those who gave positive responses, however, there was no doubt about the identity of the benefit most often perceived: it was rent stability. More than two-thirds of all the respondents who saw any benefit to them from stabilization cited this benefit, and almost all of those who cited it named it as the most important single benefit. Rent stability was cited as first priority more than four times as often as affordability, the benefit second most often mentioned. None of the other benefits cited challenged these in priority, although security and eviction protection ranked close to affordability in frequency of mention.

These data are especially interesting in the light of our earlier finding that most tenants who are willing to make such estimates believe that stabilization is saving them very substantial amounts of money. These responses suggest that, even with those perceived savings, these tenants do not, by and large, believe that stabilization is spelling the difference between affordability and rents they could not afford. This suggests, on the one hand, that popular perceptions of what can be afforded differ considerably from most of the rent-to-income ratios that are used to measure affordability. On the other hand, the fact that stability so far outstripped affordability as a perceived benefit of rent stabilization despite the large perceived dollar savings suggests that tenants place a very high value upon the non-monetizable benefit of stability in the rents they are charged.

Turning to the other side of the coin, the responses indicated that most tenants, whether knowledgeable about rent stabilization or otherwise, thought that it was not doing them

any harm. Only 16% of all respondents cited any harms at all. Of the harms cited, the tendency of stabilization to discourage building improvements and to encourage annual rent increases were by far the most often cited. Complaints that the Ordinance's 7% ceiling on increases was too high were very infrequent, as were all other specific criticisms.

Looking across the spectrum of the possible non-monetizable benefits and costs of rent stabilization, this analysis suggests several broad conclusions. First, although reduced tenant mobility in the Los Angeles area has in fact resulted in longer average tenure in a given dwelling unit, stabilization does not seem to have had any noticeable effect on this trend. Second, a non-trivial number of Los Angeles tenant households owes the affordability of their present housing to the institution of rent stabilization, and that fact has probably increased their sense of security of tenure. Third, tenants do not cite much positive or negative personal experience with the phenomena cited in arguments for and against stabilization, but get most of their information on this score from the press.

Finally, although most tenants think they are getting large financial savings from rent stabilization, they appear to prize the stability that they think the program brings to rental charges as much or more than the money saved. And, very few tenants of any persuasion believe that rent stabilization does them any actual harm.

2.5 Summary of Benefit/Cost Flows

Our analyses of the benefits and costs attributable to rent stabilization confirms that its major effects upon tenants are distributional as among them, rather than as between tenants and landlords. Though the flow of subsidy from landlords to tenants is not negligible, it is dwarfed by the subsidies and offsetting overpayments that tenants make as the Los Angeles rental market just about keeps overall pace with the averages registered in surrounding unstabilized cities.

Which tenants receive subsidies and which pay higher rents than they would pay without stabilization is closely associated with how long a household has occupied its unit. Those who have not moved at all since the enactment of stabilization are the prime beneficiaries; those who have been in their units for one to two years are the prime subsidizers. This tends to concentrate the subsidies in elderly, single-member, low income households housed in smaller buildings, while concentrating the overpayments in younger, larger, higher-income households living in larger buildings. Members of racial/ethnic minority groups do not receive as much subsidy as whites, on the average, but within the white population the subsidy is heavily concentrated in single-member elderly households. And, even after receiving these subsidies, elderly households still pay a higher average portion of their incomes for shelter than do households of any other age.

The scale of the subsidy flow is sufficient to make their present housing affordable for 12-25,000 Los Angeles households which would not otherwise be able to fit their rents within standard affordability shares of their income. However, needy families who have moved in recent years often receive no benefits from stabilization, and about one-fourth of the long-tenured tenants -- the primary beneficiaries of stabilization -- earn more than \$40,000 per year.

Finally, whatever the figures may show, most stabilized tenants who state opinions about the financial effect that rent stabilization has upon them believe that it is saving them substantial amounts of money. They also believe that it is providing important non-money benefits, of which the most highly prized is stability in the rents charged. Very few tenants believe that stabilization can harm their interests. The evidence suggests little to no tenant recognition that the major benefit/cost flows traceable to rent stabilization occur within the tenant population rather than between tenants and landlords.

1A detailed description of the scope and methodology of this survey is presented in Appendix A.

2This is a Federally standardized statistical unit which includes all of the counties that house portions of the Los Angeles metro-pole.

3The 1977 AHS survey excluded all single-family units. However, some single-family units were included in the 1984 sample where the household indicated residence on the same lot where more than three units were located, a situation which, if certain other conditions are met, makes the single-family unit subject to rent stabilization.

4It is incorrect to adjust the 1984 sample in the same way because the Ordinance permitted a 1979-only exclusion on luxury grounds. Thus, even if the 1984 rental for a given unit exceeded the cut-off and had done so for the previous four years, it could not have become exempt from rent stabilization so long as the rent charged in 1979 was below the cutoff figure. The cutoffs were \$302 per month for an efficiency unit, \$420 for a one-bedroom, \$588 for a two-bedroom and \$823 for a unit with four or more bedrooms.

5Although a total of 3,150 surveys were actually completed in the 1984 exercise, the sample inclusion and exclusion criteria cited above resulted in a smaller number being subjected to analysis.

6The 1984 survey returns indicated that 85% of rent-stabilized tenants paid their own electric bills, while 15% paid rents which included electric service. As for gas, 72% of the respondents reported paying their own, 21% reported that gas was included in their rent, and 7% reported no gas service.

7Throughout this Report, "utilities" means gas and electricity. The Los Angeles rent stabilization Ordinance permits landlords who pay utility bills directly to add an annual increase of up to 1% of base rent, above the 7% annual ceiling on such increases, for each of these utilities that is included in the rent.

8The 1984 tenant survey asked respondents to state their total household income. If they refused to provide an exact figure, they were asked for household income rounded to the nearest \$5,000. In the end, about 54% of the survey respondents reported an income that was an exact multiple of \$5,000 (e.g., \$10,000, \$15,000, etc.). Although it is not possible to distinguish between instances in which these were rounded figures and cases where they were reasonably precise, there was a possibility that rounding might bias the rent-to-income ratios. To gauge the magnitude of this possible bias, we rounded the 1977 income reports to the nearest \$5,000 and re-estimated the rent-to-income ratios for that year on the basis of the rounded income data.

The average value of the resulting ratios was about 0.01 higher than the 1977 ratios generated by the actual reported incomes.

⁹Estimates of the average annual compounded rate of increase are based on the full 7 1/2 years that elapsed between the dates of the two surveys.

¹⁰The housing amendments contained in the Omnibus Budget Reconciliation Act of 1981 (Public Law 97-35) increased maximum tenant contributions to rent in Federal Public Housing and Section Eight programs from 25% to 30% of tenant income. The 30% standard was made effective for new tenants beginning August 1, 1982.

¹¹Note that the data for control households have been weighted to make their incomes -- and hence their income gains -- identical to those experienced in the City. As a result, the smaller increase in gross rent-to-income ratios in Los Angeles does reflect the smaller increase in rents, not differences in income behavior.

¹²"Length of tenure" refers to the number of years that a given household has lived in its dwelling unit.

¹³Although rent stabilization became effective in Los Angeles in 1979, the base year for calculating allowable increases was rolled back to 1978.

¹⁴The simulation of maximum allowable rent was derived by first estimating the number of times that the rent could lawfully have been raised during the period that the household has been in residence by dividing the number of months of residence by 12 and then rounding down to the nearest whole number. Call the resulting estimate "n." The simulated allowable rent figure was then derived by multiplying the rent reported at movein by $(1 + r)^n$, where "r" ranged from 7% to 9%, depending on utility payment arrangements.

¹⁵The row in the Exhibit labeled "Don't know maximum" reflects people who felt they knew enough to respond to at least one of these questions, but did not know the quantitative ceiling set in the Ordinance.

¹⁶Reasonable people can differ as to whether the incidence of more than one person per room is an accurate measure of undesirable density. We intend no judgment on that here. The term "crowding" is used solely because of its simplicity, and may be considered a synonym for "population density per unit."

¹⁷A unit was recorded as having "incomplete plumbing" if it was missing hot or cold piped water, a flush toilet and/or a bathtub or shower.

¹⁸Heating equipment was classified as "inadequate" if the unit had

none or was heated only by a fireplace or portable room heater.

¹⁹These "less serious" defects included exposed electrical wiring; open cracks and holes and/or broken plaster in interior walls and ceilings; holes in the floor; presence of rats or mice; broken lighting fixtures in the common areas of the building; loose, broken or missing steps in common stairways; and stove, sink, or refrigerator not in good working condition.

²⁰Although the data are not reported herein, this trend toward higher density is also evident in the results of the 1980 Annual Housing Survey.

²¹The other choices offered to respondents were "somewhat dissatisfied" and "very dissatisfied."

²²All estimates of financial effects are confined solely to rent. The estimates have not been adjusted to correct for any welfare loss or gain ascribable to over- or under-consumption of housing that may be influenced by the behavior of rents.

²³Both this concept and the Market Rent concept of unstabilized rent levels do include payments for utilities, whether or not they are included in contract rent.

²⁴The rate of increase derived under the Imputed Rent concept was a bit higher than the 11% increase suggested by comparison of the mean rentals reported outside the City in the survey, and a good deal higher than the 9.2% suggested by Federal Bureau of Labor Statistics data on trends in the metropolitan area between 1977 and 1984.

²⁵Please note that this is the figure previously identified as "contract rent," not the "gross rent" figure used earlier to compare tenants inside and outside the City.

²⁶These estimates were the result of a pooled, semi-log regression. The difference between the 1977 and 1984 coefficients is highly significant for households with six or more years of occupancy and relatively weakly significant (85% confidence level) for households with fewer than three years of occupancy.

²⁷According to the HUD classifications, a "very low" income for a household with four members is one that is less than 50% of the areawide median, or less than about \$14,400 in 1984. A "low" income household would fall between 50% and 80% of the median (\$14,400 to \$23,050). A "moderate" income household's income would be 80% to 120% of the median (\$23,050 to \$34,560). Somewhat different cutoffs are used for households larger or smaller than four.

²⁸The regression technique used to make these calculations does not produce nearly as high confidence levels in predicting the respective size of these two groups as in predicting their

average experience.

²⁹Appendix C presents further breakdowns, including race by age and race by income.

³⁰This distribution is somewhat different from the one presented earlier in Exhibit 2-2 because this one is restricted to households for whom benefit/cost calculations could be made.

CHAPTER 3

THE IMPACT OF RENT STABILIZATION ON LOS ANGELES APARTMENT OWNERS

This Chapter explores the impacts of rent stabilization on the financial characteristics of Los Angeles residential multi-family rental properties, and on the returns realized by the owners of these properties. The analysis consists of two principal components. First, we adopt a historical perspective, examining rates of return generated by apartment properties inside and outside the City of Los Angeles, over the period 1970-1984. Next, we focus in greater detail on the current financial conditions of properties inside and outside the City, and on important changes that have occurred since 1977. The Chapter concludes with a brief summary of findings.

3.1 Rates of Return Before and After Stabilization

One way to examine the impact of rent stabilization on real estate investment is to trace the rates of return realized before and after stabilization was enacted. This section presents the results of such an analysis -- comparing the behavior of various rate-of-return measures inside Los Angeles and in surrounding unstabilized jurisdictions in the years 1970-1984.

Our rate-of-return calculations are based on information about residential property sales for each year from 1970 to 1984. Data for the years 1970 to 1976 were obtained from volumes published by the Society of Real Estate Appraisers (SREA), and consist of roughly 400 property sales sampled from each year. Data for the years 1977 to 1984 were provided on magnetic tape by the

DAMAR Corporation. The sample sizes in these years range from about 425 in 1982 to almost 5,000 in 1978. As in the foregoing analysis of tenant benefits, the properties outside the City that were used for comparison here were drawn from the cities of Burbank, Glendale, Inglewood, Long Beach, Pasadena, and Torrance, all of which adjoin Los Angeles and none of which have enacted rent stabilization systems. Appendix D presents the number of properties -- both inside and outside Los Angeles -- in each year's sample.

Calculating annual rates of return requires annual estimates of property values, revenues, and operating expenses inside and outside Los Angeles. To control for changes over time in the attributes of properties sold and for differences between properties inside and outside the City, we employed the following, three-step process:

- * Regression equations were estimated for each year, expressing per-unit values, revenues, and operating expenses as a function of property characteristics and location.
- * Typical attributes of large and small properties were substituted into these annual regression equations to yield estimates of each year's values, revenues, and expenses for properties of constant quality.¹
- * At the same time, the variance (or estimation error) of each regression estimate was computed, to yield an overall estimate of the range of variance of our return measures.

The details of this methodology are reported in Appendix E.

The property attributes that were used to generate annual estimates for value, revenues, and expenses represent two "prototypical" residential rental properties in the Los Angeles area. One represents small properties (consisting of fewer than six units) and the other represents larger properties (12 or more units). By focusing the rate-of-return analysis on "prototypical" properties, we were able to compare the returns realized by Los Angeles and non-Los Angeles property owners who owned similar properties, and to examine changes over time in the returns generated by a particular type of property. In other words, this approach protected the analysis from skewing by spurious trends

stemming from year-to-year shifts in the composition of property sales and from systematic differences between the Los Angeles and non-Los Angeles rental housing stocks.

The central focus of the analysis is on differences in the returns yielded by Los Angeles and non-Los Angeles properties over the years 1970-1984. Therefore, we begin by examining trends in the behavior of the simplest possible measure of return -- the pre-tax return on the total value of the property. This measure tells us, on an annual basis, the gross level of return generated on average by a particular type of rental property. It does not take into account the effects of the owner's financing costs or income taxes. However, because of its simplicity, pre-tax return on value provides a useful way of comparing returns on comparable rental properties under changing circumstances.

After examining patterns in the pre-tax return on value, we incorporate the effects of taxes and financing into the analysis, tracing both after-tax returns on value and after-tax returns on the owner's equity in the property. While these measures come closer to reflecting what landlords actually realized on their real estate holdings, they require that we make specific assumptions about holding periods, financing arrangements, tax rates, and tax strategies. Since these assumptions may or may not reflect the actual circumstances of a given property owner or group of property owners, the results should be viewed as illustrative, and should be used primarily to compare returns over time and across locations. They should not be viewed as definitive measures of the actual investment return realized by landlords.

3.1.1 Pre-Tax Return on Property Value

As noted above, pre-tax return on value represents the simplest measure of the gross return generated by real estate investment during a given year. It focuses on net operating income and appreciation in the value of the property, ignoring the specific financing and tax arrangements of individual investors. Thus, it is an excellent measure for examining the basic

performance of comparable investments under changing circumstances, although it is not a good indicator of what typical investors actually realize (after taxes) on their invested equity.

It is important to note that the formula² used to calculate pre-tax return bases the measure on properties' current value, rather than on its purchase price, and that the formula incorporates each year's property appreciation into the current year's return, rather than postponing all appreciation to the time of sale. Exhibit 3-1 reports annual pre-tax returns on value for our two prototypical properties, if located inside or outside the City of Los Angeles, for the period 1970-1984. Statistically significant differences between returns inside and outside the City are indicated with asterisks.

The first major finding that emerges from the Exhibit is that rates of return to the value of residential rental real estate in the Los Angeles area varied greatly from year to year. For example, returns on large properties inside the City ranged from a loss of 1.3% in 1972 to a gain of 64.3% in 1976. The same large fluctuations characterized experience in contiguous cities. This variability is attributable both to fluctuations in the rate at which revenues and operating costs increased, and to periodic lulls in the rate of appreciation of property value.

In reviewing the Exhibit, the reader should note that the extremely high rates of return derived for 1976 may in part reflect problems in merging the SREA and DAMAR data sets. Average values (and operating costs) are both shown as rising significantly between 1976, the last year covered by the SREA data, and 1977, the first year covered by the DAMAR data. This increase in property values is included in calculation of the 1976 rate of return. Although both the SREA and DAMAR data are based on the same type of information, the sampling procedures employed by the two organizations could well differ. As a result, estimates returns in 1976 should be viewed with caution. For this reason, the 1976 data line has been shown out of order at the bottom of the Exhibit.

EXHIBIT 3-1

PRE-TAX RETURNS ON VALUE: 1970 - 1983

	Small Properties		Large Properties	
	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>
1970	15.7%	15.7%	9.8%	10.1%
1971	7.7	2.1	15.4	9.4
1972	13.8	9.7	-1.3	-5.6
1973	31.2	42.4	28.4	41.7
1974	33.5	23.8	28.8	16.4
1975	20.0	30.0	16.0	50.0
1977	12.5*	20.0*	20.7*	31.8*
1978	24.8*	30.3*	18.2*	24.8*
1979	7.0***	18.3***	37.0***	51.6***
1980	4.2***	16.1***	11.0***	22.5***
1981	19.1*	9.4*	15.5	6.6
1982	17.4	12.4	15.8	10.8
1983	17.9*	8.4*	14.1*	4.5*
(1976	70.4**	50.4**	64.3**	40.7**)

* indicates differences that are statistically significant at a 90 percent confidence level

** indicates statistical significance at a 95 percent level

*** indicates statistical significance at a 99 percent level

The second finding evident from the Exhibit is that, while annual rates of pre-tax return were fairly similar inside and outside of Los Angeles during the early 1970s, the two areas followed somewhat different paths between 1975 and 1983, the period that includes the institution of rent stabilization in the City. Returns inside Los Angeles were markedly lower than in surrounding areas in 1975 and again from 1977 through 1980. Then, from 1981 through 1983, properties inside the City of Los Angeles produced higher rates of pre-tax return than those in surrounding jurisdictions without rent stabilization.³ In other words, during the years immediately preceding and following the enactment of rent stabilization in Los Angeles, rates of pre-tax return to the owners of apartment property in the City were significantly lower than those generated by comparable properties in adjoining unstabilized jurisdictions, but by 1983, Los Angeles apartment properties were again generating returns that were competitive or better than those registered in the unstabilized areas.

This pattern is consistent with the way that economic theory would lead one to expect investment markets to behave, given that the measure of annual pre-tax return is based on current market values. The flow of capital between alternative investments should tend to equalize expected rates of return in assets of comparable risk. Thus, following a reduction in building income, one would expect property values to fall (or to rise relatively slowly) until rates of return are roughly comparable to those of competing investments. This is not to say that owners of such properties did not suffer a loss during the downturn, but rather that new investors entering the market after such an adjustment can expect to obtain returns comparable to those available from other types of investments.

This adjustment process also seems evident from the data presented in Exhibit 3-2, which traces cumulative changes in property values and net operating income (NOI) inside and outside the City between 1970 and 1984. Separate data are again presented for large and small properties. Trends in property values and net

EXHIBIT 3-2

CHANGES IN PROTOTYPE VALUES AND NET
OPERATING INCOMES: 1977-1984

	VALUE				NET OPERATING INCOME			
	Small Prototype		Large Prototype		Small Prototype		Large Prototype	
	Inside Los Angeles	Outside Los Angeles	Inside Los Angeles	Outside Los Angeles	Inside Los Angeles	Outside Los Angeles	Inside Los Angeles	Outside Los Angeles
1970	100	100	100	100	100	100	100	100
1971	109	109	102	103	88	115	194	216
1972	111	104	104	97	100	104	111	113
1973	120	107	94	84	255	468	181	366
1974	140	122	108	93	126	124	125	109
1975	178	143	130	100	153	138	179	166
1976	178	173	139	136	167	140	232	209
1977	292	251	211	176	214	214	210	210
1978	314	287	239	217	239	243	227	230
1979	376	358	265	255	281	284	255	258
1980	382	405	345	367	310	340	348	374
1981	377	447	357	424	312	305	408	400
1982	428	470	382	423	394	416	310	329
1983	475	500	420	446	384	391	415	420
1984	534	517	448	436	499	543	478	515

operating income have both been measured by indices which were set at 100 in the initial year of the period. These data show that between 1970 and 1977 property values rose at a somewhat higher rate within Los Angeles than they did in the surrounding areas, but that since 1977 this pattern has been largely reversed. They also show that most of the change occurred in the initial years of rent stabilization.

For example, between 1977 and 1981, the value of small properties rose by about 29% within the City, compared to 78% in surrounding unstabilized areas. Then, beginning in 1981, property values in the City began to rebound, while appreciation in surrounding communities slowed appreciably. This analysis indicates that over the entire 15-year period, owners of property in the City have experienced a slightly higher rate of appreciation of values than have their counterparts in neighboring unstabilized cities, while the non-City landlords have experienced a somewhat higher growth in net operating income. But if one looks only at the period since 1977, despite the reversal that started in 1981, Los Angeles landlords have not yet caught up with their counterparts in unstabilized areas in terms of the rate of property value appreciation that has occurred there during the years 1977-81.

A similar picture emerges if, in recognition of the possible dataset interface problem discussed above that may affect the 1976 figures, one resets the index at 100 in 1977. Exhibit 3-2a displays the results of this approach. Again, the reversal of relative fortunes as between City and non-City landlords since 1977 appears.

Thus, over the course of the rent stabilized period, the values of small buildings have increased by about 83% within the City, compared to 106% in surrounding unstabilized areas. Similarly, the values of large buildings inside Los Angeles have increased 112% in these years, while the values of those outside have risen by 148%.

EXHIBIT 3-2 (a)

CHANGES IN PROTOTYPE VALUES AND NET

OPERATING INCOMES: 1970 - 1976, 1977 - 1984

	VALUE				NET OPERATING INCOME			
	Small Prototype		Large Prototype		Small Prototype		Large Prototype	
	Inside	Outside	Inside	Outside	Inside	Outside	Inside	Outside
	<u>Los Angeles</u>	<u>Los Angeles</u>	<u>Los Angeles</u>	<u>Los Angeles</u>	<u>Los Angeles</u>	<u>Los Angeles</u>	<u>Los Angeles</u>	<u>Los Angeles</u>
1970	100	100	100	100	100	100	100	100
1971	109	109	102	103	88	115	194	216
1972	111	104	104	97	100	104	111	113
1973	120	107	94	84	255	468	181	366
1974	140	122	108	93	126	124	125	109
1975	178	143	130	100	153	138	179	166
1976	178	173	139	136	167	140	232	209

CHANGES IN PROTOTYPE VALUES AND NET

OPERATING INCOMES: 1977 - 1984

1977	100	100	100	100	100	100	100	100
1978	108	114	113	123	112	114	108	110
1979	129	143	126	145	131	133	121	123
1980	131	161	164	209	145	159	166	178
1981	129	178	169	241	146	143	194	190
1982	147	187	181	240	184	194	148	157
1983	163	199	199	253	179	183	198	200
1984	183	206	212	248	233	254	228	245

The data also suggest that rent stabilization is associated with a dampening effect on the growth of net operating income in Los Angeles. The estimated trends are sometimes erratic, primarily due to the small sample sizes that were available in some years. Nevertheless, it appears that NOI increased by about the same proportionate amount inside and outside the City between 1970 and 1977, but that income growth within the City has been considerably lower than in surrounding unstabilized areas since the enactment of rent stabilization. Between 1977 and 1984, for example, NOI from small properties rose by about 133% within the City, compared to 154% in surrounding areas. The corresponding figures for large properties were 128% and 145%, respectively.

The net effect of these changes in values and income was to reduce the average rate of pre-tax return that has been earned by owners of City rental property since stabilization was introduced, both as compared with historical rates of return and as compared with rates in surrounding unstabilized areas. For example, the average (compounded) rate of pre-tax return for small properties in the City during the years 1970-77 was about 25.6% per year, compared to about 24.3% per year in surrounding areas. However, between 1977 and 1984, small properties earned an average of 14.7% per year in Los Angeles, compared to 16.4% per year in surrounding areas. (If the 1976 data are excluded from the basis for this calculation, the average rate of return on small buildings between 1970 and 1977 works out to 18.9% in Los Angeles and 19.9% outside the City.) It will be noted that properties in both areas generated substantially lower annual rates of pre-tax return during the economically turbulent 1978-83 period, but that the City properties were a bit harder hit and their relation to the earning power of non-City properties was reversed.

It seems very probable that much of this reversal reflects sluggish growth in property values that occurred in the early years of rent stabilization. During these early years (1977 to 1981), the return on small properties in the City of Los Angeles averaged about 13.5% per year, well below the 18.8% average registered in adjoining unstabilized cities.

Patterns are somewhat different for larger properties, particularly with respect to the pre-rent stabilization period. While overall appreciation of the values of these properties between 1970 and 1977 was again somewhat higher within the City, -- and while the growth in NOI was about the same -- the average compounded rate of return was slightly lower in Los Angeles than it was in surrounding areas (21.5% vs. 22.9%). However, this apparent difference is largely attributable to the extremely high rate of return reported in uncontrolled areas in 1975. Since the sample for that year was relatively small, and since the differences in rates of return do not test out as statistically significant, this result may be misleading. Excluding 1975 from the calculations produces an average return of 22.3% within the City, as against 19.5% in surrounding areas, showing the great sensitivity of the findings to the unusual data recorded in the sample for that year.

Moreover, for the post-rent stabilization period, patterns for larger properties are comparable to those observed for smaller buildings. The average annual rate of return between 1978 and 1980 was 21.6% within the City, compared to 32.3% in unstabilized areas. However, over the entire rent stabilized period (1978 to 1983), the differentials are considerably smaller, with an average rate of 18.3% for Los Angeles buildings, compared to 19.1% in surrounding unstabilized areas.

These findings are generally consistent with the analysis of tenant benefits and costs presented in Chapter 2. Assuming that, in the absence of rent stabilization, rents would have risen by the same amount as they did in unstabilized surrounding areas (i.e., the Imputed Rents standard of measurement), we found that the average savings from rent stabilization to all tenants taken together were positive, but fairly small. Applying that same concept to our comparative analysis of pre-tax rates of return to landlords, we find that, taken as a whole, rental properties subject to stabilization would have earned about 2% more per year over the years 1977-84 if rent increases had not been regulated. However, it also appears that the Los Angeles apartment rental

market is rebounding (at least in relationship to surrounding areas), and has been doing so since about 1981. Again, this is consistent with our earlier finding that the benefits delivered by stabilization to long-tenured residents have been largely offset in recent years by premiums charged to more mobile households.

Turning back to the full 15-year period, 1970-84, whether one believes that rent stabilization has done harm to Los Angeles landlords over the longer term depends upon whether one believes that, in the absence of rent stabilization, City properties would have generated consistently higher returns than those in surrounding cities. Though the differences are not always statistically meaningful, the data tend to show that the pre-tax rates of return for Los Angeles buildings were in fact somewhat higher during the pre-stabilization portion of the period, whereupon they dipped noticeably below those of unstabilized areas. Now they have rebounded to a roughly comparable level, registering markedly higher returns in the most recent past. As a result, the average annual rate of return between 1970 and 1984 was roughly comparable inside and outside the City, regardless of building type. If one finds equivalent performance in the City acceptable, then the long-term harm was minimal. If, however, one believes that City investments should regularly outperform those in surrounding areas, then it is possible to argue that rent stabilization has had harmful effects over the longer term. This is not a choice of perspective that can be dictated by the data.

3.1.2 Impact of Financing Costs and Taxes

Having observed the patterns described by simple pre-tax returns on value, we now examine variations attributable to financing costs and taxes. It is well known that mortgage financing, tax deductions, and marginal tax rates are critical determinants of the ultimate profitability of all real estate investments. Thus, by incorporating tax and financing parameters into our rate of return measures, we can come closer to estimating the

profitability of residential real estate relative to alternative investment opportunities. In addition, we can identify circumstances in which major tax law or interest rate shifts may have exaggerated or obscured the impacts of rent stabilization on the rate of return actually realized by property owners.

It is important to note, however, that the annual property sales data upon which our historical analysis is based do not include information on taxes or financing costs. Therefore, our analysis must be based on a set of tax and financing assumptions, which are summarized in Appendix F. In addition, once tax and financing considerations are incorporated, it is impossible to calculate a generic annual rate-of-return measure that is independent of how long the property is held by a given owner. This stems from the fact that interest rates, interest payments, accumulated equity, and depreciable basis all depend upon when a property was purchased. Therefore, we have calculated two types of return measures. The first computation is a series of return measures for each year, allowing the year of purchase to vary. The second computation calculates "internal" rates of return (see below for a definition of this term) for all possible holding periods of not less than one calendar year during the period 1970-84. These results are reported fully in Appendix G. The remainder of this section summarizes the key findings that emerge from this analysis.

We begin by focusing on properties purchased in 1970 and held through 1984, for which the rates of return are shown in Exhibit 3-3. Annual after-tax returns on value and equity are reported for both of our prototypical properties, located inside and outside of the City of Los Angeles.⁴ Returns in each year are again expressed in relationship to current property values (or current accumulated equity). However, certain expenses -- such as depreciation and financing costs -- often do not vary over time, but instead are tied to mortgage rates and property values in the purchase year assumed here (1970).

EXHIBIT 3-3

ANNUAL AFTER-TAX RETURNS: 1970-1984

	After-Tax Return on Value				After-Tax Return on Equity			
	Small Properties		Large Properties		Small Properties		Large Properties	
	Inside LA	Outside LA	Inside LA	Outside LA	Inside LA	Outside LA	Inside LA	Outside LA
1970	10%	10%	6%	6%	38%	38%	16%	18%
1971	5%	0%	8%	3%	9%	-7%	23%	3%
1972	9%	6%	-2%	-5%	22%	14%	-19%	-39%
1973	18%	22%	17%	21%	46%	71%	78%	226%
1974	22%	15%	19%	10%	45%	36%	56%	41%
1975	3%	18%	9%	30%	3%	34%	17%	109%
1976	48%	34%	42%	26%	79%	57%	86%	53%
1977	8%	14%	14%	22%	10%	18%	19%	35%
1978	17%	21%	12%	17%	21%	27%	15%	23%
1979	4%	12%	26%	37%	4%	15%	34%	50%
1980	1%	11%	6%	15%	1%	12%	7%	17%
1981	14%	6%	10%	4%	16%	7%	12%	3%
1982	12%	8%	11%	7%	14%	9%	13%	8%
1983	13%	5%	9%	2%	14%	6%	10%	1%

Several findings are supported by this Exhibit. First, the volatility of annual returns is illustrated once again. Annual rates of returns vary widely and suddenly from year to year. Second, after-tax returns on value follow the same pattern exhibited by simple, pre-tax returns on value (Exhibit 3-1). Of course, after-tax returns are consistently lower, since tax liabilities reduce both cash-flow and appreciation.⁵ After-tax returns on equity are considerably higher, primarily because the equity base is only a portion of the total value of the property base, but also because properties yield tax losses in the early years of ownership.

Finally, despite the volatility of annual returns, we can observe that returns for properties inside Los Angeles were reduced markedly immediately following the enactment of rent stabilization, but that by the end of 1983 annual returns in Los Angeles were again higher than those generated by properties in surrounding unstabilized areas. This pattern is similar to what we have seen with respect to pre-tax return on value.

Because the variability of annual returns makes it difficult to discern notable changes in rates of return from one period to another, it is useful to examine average returns earned over several holding periods. Exhibit 3-4 presents average annual after-tax returns on value and equity for four different holding periods: 1970 to 1977 (the period just prior to rent stabilization); 1978 to 1983 (the full rent-stabilized period); 1978 to 1980 (the initial years of rent stabilization); and 1981 to 1983 (the most recent past). Although these holding periods are too short to simulate the situation of the "average" investor, they do serve to illustrate important differences in rates of return over time.

The figures presented in Exhibit 3-4 again show that, before the enactment of rent stabilization in Los Angeles, properties both inside and outside of the City generated roughly comparable returns. Rent stabilization appears to have depressed annual returns from Los Angeles properties for a relatively brief period. Since 1981, however, the analysis suggests that unstabilized

EXHIBIT 3-4

AVERAGE HOLDING PERIOD RETURNS

AFTER-TAX RETURNS ON VALUE

	<u>Small Properties</u>		<u>Large Properties</u>	
	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>
1970-77	14.6%	14.5%	13.5%	13.5%
1978-83	10.5%	11.2%	12.5%	13.4%
1978-80	7.8%	15.2%	14.7%	22.9%
1981-83	14.0%	7.7%	11.0%	5.3%
1970-83	12.6%	12.7%	12.9%	13.3%

AFTER-TAX RETURNS ON EQUITY

	<u>Small Properties</u>		<u>Large Properties</u>	
	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>
1970-77	29.4%	30.6%	30.3%	39.9%
1978-83	26.1%	27.4%	30.8%	32.4%
1978-80	25.2%	47.1%	46.1%	67.0%
1981-83	36.2%	14.5%	27.5%	3.8%
1970-83	21.4%	22.5%	23.4%	29.1%

properties outside the City have yielded very low returns, while returns from properties inside the City have rebounded substantially. Thus, while average returns over the entire rent-stabilized period are still significantly lower in Los Angeles, the differential seems to be shrinking rapidly.

Exhibit 3-5, which presents "internal" rates of return for each holding period, provides further support for the same conclusions. Internal rates of return are calculated quite differently from annual rates of return. Principally, the internal rate calculation uses initial value or equity as a base, rather than current value, and it postpones all appreciation of value until the end of the holding period, rather than recognizing appreciation annually. For any given property during any period, the results of this analysis differ considerably from those yielded by the annual rate method. The internal approach alters the volatility of year-to-year change. Still, as the Exhibit demonstrates, internal rate of return analysis also shows Los Angeles rental properties as suffering a drop in their relative rates of return in the early years of stabilization, but then rebounding in recent years to a 1984 position that is just a bit below the 1977-84 performance of unstabilized areas and improving much more rapidly than are rates in those areas.

3.2 Current Income and Expense Patterns in Rent-Stabilized Apartments

This section takes a closer look at the current financial conditions of the owners of multifamily residential rental property in the City. The bulk of the analysis is based on a detailed 1984 survey of building expenditures circulated to a random sample of Los Angeles landlords, as well as to a smaller random sample of landlords owners in surrounding, unstabilized areas. However, whenever possible, the survey results are compared to comparable information obtained from other data sets. This analysis enables us to compare the current income, expenses,

EXHIBIT 3-5

INTERNAL RATES OF RETURN ON EQUITY

(HIGH TAX)

	<u>Small Properties</u>		<u>Large Properties</u>	
	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>
1970-77	44%	43%	44%	41%
1977-84	15%	16%	17%	17%
1977-81	8%	12%	13%	16%
1981-84	8%	4%	7%	2%
1970-84	16%	16%	16%	16%

and financing arrangements in stabilized and unstabilized rental properties, and in a variety of building types. It also enables us to examine trends in income and expenditures since the introduction of rent stabilization. Finally, the data provide the basic information on the composition of owner expenditures that is needed to construct the cost-based rent adjustment formula presented later in Chapter 4.

The section begins with a brief description of the survey of property owners and the characteristics of the underlying sample. A more detailed description of the sampling procedures and the data collection effort is presented in Appendix A. We then use the survey results to examine building income and expenses in 1983, both inside and outside the City, and for a variety of building types. Subsequent sections then examine trends in income and expenses between 1977 and 1983; current property values and invested equity; and the amount and types of mortgage financing reported. The section concludes by comparing the information obtained from the landlord survey to similar data derived from two other sources: (1) metropolitan-wide statistics for large rental properties published annually by the Institute for Real Estate Management (IREM); and (2) special statistics on the rent stabilized properties compiled by the California Franchise Tax Board (FTB).

3.2.1 The Survey of Property Owners

As part of the study, a detailed survey of building income and expenses was fielded to a random sample of over 3,300 owners of multifamily residential rental properties in the Los Angeles area. A total of 311 landlords responded to the survey, 262 in Los Angeles and 49 in surrounding unstabilized areas. The unstabilized cities appearing in this sample are the same as those used elsewhere in the analysis and include: Long Beach, Pasadena, Torrance, Glendale, Inglewood and Burbank. Sixty of the completed surveys were subsequently dropped from the analysis due to incom-

plete or inconsistent financial data.⁶ As a result, the final sample contained a total of 251 different properties with 2,289 rental units.

Exhibit 3-6 presents some basic information on this sample, and compares its characteristics to those of the universe of rent-stabilized properties currently registered with the City's Rent Stabilization Division. As is evident from the Exhibit, the properties included in the Los Angeles element of the survey sample have a size distribution that is roughly comparable to the distribution of all stabilized units. The geographic distribution by Labor Market Planning Area (LMPA) is also about the same. The element of the sample composed of unstabilized properties in contiguous cities was purposely shaped for approximately even distribution among the six communities represented in the survey, and the distribution of units by building size is roughly comparable to the distribution observed in the Los Angeles sample.

As noted in the analysis of tenant benefits, residents of adjoining unstabilized areas tend to have higher incomes and fewer members of racial/ethnic minorities than live in stabilized areas within the city of Los Angeles. Although the mix of units by building size is about the same, unstabilized properties may well house a more prosperous segment of the metropolitan population than the properties included in the Los Angeles sample. To assess this potential bias, we compared the two samples based on a number of key building attributes, including the average size of units and the presence or absence of certain amenities. These data are presented in Exhibit 3-7. Although the Los Angeles sample contains a higher proportion of studio apartments, the average unit size is about the same inside and outside the City. Los Angeles properties also tend to be older than unstabilized buildings, although both samples purposely exclude recent construction that would not be subject to stabilization in the City.

A larger proportion of owners of Los Angeles properties assigned an "average" rating to the neighborhoods in which the properties were located than did owners of unstabilized units in contiguous cities. However, the number of above- and below-aver-

EXHIBIT 3-6

CHARACTERISTICS OF THE LANDLORD SAMPLE

	All Rent Control Properties	Final Sample	
		Los Angeles	Uncontrolled
Total Properties	70,351	208	43
Total Units	489,406	1,908	381
Distribution of Units by Building Size			
< 5 units	25%	19%	15%
6-11 units	25%	21%	26%
12+ units	50%	60%	59%
Distribution of Units by LMPA (%)			
1	7%	5%	N/A
2	18%	15%	N/A
3	31%	37%	N/A
4	23%	28%	N/A
5	17%	12%	N/A
6	4%	3%	N/A
Distribution of Properties by City			
Los Angeles	100%	100%	N/A
Long Beach	N/A	N/A	19%
Torrance	N/A	N/A	19%
Pasadena	N/A	N/A	12%
Glendale	N/A	N/A	12%
Inglewood	N/A	N/A	21%
Burbank	N/A	N/A	19%

EXHIBIT 3-7

BUILDING CHARACTERISTICS IN THE LANDLORD SURVEY

	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>
Distribution of Units by Bedroom Count		
Studio	27%	6%
One	43%	41%
Two	26%	49%
Three	3%	4%
Four or More	1%	0%
Average Unit Size	878 sq. ft.	846 sq. ft.
Date of Construction		
Before 1940	37%	24%
1940-49	24%	18%
50-59	20%	31%
60-69	15%	18%
70-Present	5%	9%
Neighborhood Rating		
Superior	4%	0%
Above Average	21%	31%
Average	59%	44%
Below Average	12%	18%
Deteriorating	4%	7%

EXHIBIT 3-7

(Continued)

	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>
Presence of Amenities (% Provided)		
Parking	82%	84%
Security	9%	7%
Swimming	11%	7%
Jacuzzi	2%	5%
Tennis	2%	2%
Sundeck	13%	11%
Laundry	43%	75%
Health Club	1%	2%
Central Air Conditioning	2%	5%
Unit Air Conditioning	22%	32%
Type of Building		
Single Family	16%	22%
Duplex	21%	16%
Three Family	8%	7%
Four Family	15%	9%
Garden Apartment	15%	24%
Other Low Rise	16%	18%
High Rise	< 1%	0%
Hotel or Rooming House	1%	0%
Condo Complex	1%	0%
Other	6%	4%

age ratings were both somewhat higher outside the City. Finally, while the presence of certain amenities and structure types differs between the areas, there is no systematic pattern of greater or fewer luxuries within Los Angeles. Thus, this potential source of bias appears to be fairly minimal.

Of greater concern is the generally low rate of response to the survey, despite strenuous efforts to maximize the number of completed questionnaires received. As with any survey of this kind, the lower the response rate, the greater the possibility that non-respondents are different from landlords who complete the survey. Given the distribution of the final sample, which closely resembles the underlying universe, the response rate does not appear to have varied by size or location of building. However, such comparisons will not detect more subtle forms of bias. For example, if landlords in the poorest financial circumstances were the most likely to respond, the survey results would under-record the profitability of stabilized apartments. If the opposite occurred, the survey data would overstate landlord income and pre-tax profit. It is impossible to determine the nature, magnitude, or existence of such a bias by reviewing the data set in isolation. However, comparisons with alternative data sets, which are made at the end of this section, should provide considerable insight into the reliability of the survey data.

3.2.2 Income and Expenses in 1983

Exhibit 3-8 presents some basic information on the average income and expenditures of rental properties reported in the survey by owners of properties inside and outside Los Angeles during 1983. Several types of data are presented, including: (1) annual gross income for the property (excluding special fees for services not included in operating costs); (2) annual operating and maintenance (O&M) costs (excluding replacements, capital improvements, and any expenses passed through to tenants); (3) annual financing costs (including interest and principal payments); (4) annual net operating income (defined as gross income

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EXHIBIT 3-8

SUMMARY OF 1983 BUILDING FINANCES

	Properties		Units ¹	
	Inside LA	Outside LA	Inside LA	Outside LA
Gross Income	\$29,840	\$42,999	\$3,262**	\$4,853**
Total O&M costs	\$12,977	\$14,098	\$1,418	\$1,591
Net Operating Income	\$16,863	\$28,900	\$1,843**	\$3,262**
Total Financing Costs ^{2,3}	\$11,841	\$15,448	\$1,273	\$1,707
Pre-Tax Cash Flow ³	\$5,123	\$14,246	\$ 551	\$1,574

** Differences are statistically significant at the 95 percent confidence level.

-
1. Unit averages were derived by weighting the unit costs of every property by the number of units it contained.
 2. Financing costs include payments for interest and principal. They have been adjusted to take out the owner's share of these expenses for owner-occupied buildings. Without this adjustment, financing costs per unit would have been \$1303 in Los Angeles and \$1722 in surrounding areas. Similarly, average profit per unit would have been \$520 and \$1559, respectively.
 3. Information on financing costs was sometimes missing, so that pre-tax cash flow could not be calculated for the full sample of properties. As a result, there is a small discrepancy between the reported average values of net operating income, financing costs, and pre-tax cash flow.

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minus operating costs); and (5) annual pre-tax cash flow (defined as net operating income minus financing costs). The first two columns present these data for the average property within each sample. The last two columns present comparable information for the average unit.⁷

The Exhibit shows that the average property in the Los Angeles portion of the sample reported gross income of \$29,840 in 1983. Average operating and maintenance costs were \$12,977, leaving a net operating income (NOI) of \$16,863. Financing costs averaged \$11,841, resulting in a pre-tax cash flow of about \$5,123. The financial conditions of buildings within the sample differed considerably, generating large margins of error around these averages. About 5% of the properties in Los Angeles reported a negative NOI (i.e., that the owner lost money on the building even before financing costs were taken into account), while almost 30% reported a negative pre-tax cash flow (i.e., that money was lost on the building after financing costs were paid).

When expressed on a unit basis, average gross income in the Los Angeles sample was about \$3,262 per year, or \$272 per month. As will be discussed in more detail below, this average gross rent is considerably below those reported in the tenant survey. Operating and maintenance costs averaged \$1,418 per unit, leaving an average net operating income of \$1,843. Financing costs averaged almost as much as operating and maintenance expenses, running \$1,273 per unit per year. As a result, pre-tax cash flow averaged \$551 per unit per year, or just under \$46 per month. Less than 2% of all units generated a negative NOI, while about 25% lost money after financing costs were paid. The proportion of units with a negative NOI is lower than the proportion derived for buildings because no property with more than 12 units reported operating expenses that exceeded building income.

The data received from the owners of unstabilized properties outside the City indicated that gross income is significantly higher outside of Los Angeles. While average operating and financing costs also ran higher in unstabilized areas, the differences did not register as statistically significant at a 95%

confidence level because of the small size of the non-Los Angeles sample. Average cash flow and NOI were likewise reported as higher outside the City, although the difference in per-unit cash flow is also not statistically significant. About 29% of all non-Los Angeles properties (and about 22% of all units) reported a negative cash flow. However, only about 2% of the properties (and half of one percent of the units) reported a negative NOI.

Exhibit 3-9 presents operating costs, financing costs, and pre-tax cash flow as a proportion of building income. It is evident that both operating and financing costs in the Los Angeles sample appear to represent a higher share of average building income than they do in unstabilized areas (although only the difference in the operating costs-to-income ratios is statistically significant). The operating costs of properties in the City were reported at about 43 percent of building income, compared to about 33% in surrounding areas. Similarly, financing costs averaged about 39% of building income in the City, compared to 35% in unstabilized areas. As a result of these differences -- which stem from the fact that average gross income from the property was reported as significantly lower within the City than outside -- pre-tax cash flow averaged out to about 17% of building income in Los Angeles, compared to 32% in surrounding areas.

Exhibit 3-10 presents additional breakdowns of income and expenditures by building size, utility inclusion, date of purchase (pre-or post-rent stabilization), residence of owner (on or off-site), scale of landlord holdings (measured by the total units owned) and LMPA location. The figures in the Exhibit are all expressed on a unit basis and pertain only to the Los Angeles sample. (Note that the number of observations in some of the LMPAs is extremely small, making the estimates for these areas unreliable.)

In general, operating and maintenance costs per unit appear to increase with building size, and the differences are statistically significant. However, since large buildings also have higher rents, net operating incomes are about the same regardless of building size. Financing costs appear to be significantly lower

EXHIBIT 3-9

RATIOS OF OPERATING COSTS, FINANCING COSTS, AND CASH FLOW TO BUILDING INCOME: 1983

	<u>Inside Los Angeles</u>	<u>Outside Los Angeles^a</u>
Operating Costs/Total Income	43.4% ***	32.8% ***
Financing Costs/Total Income	39.0%	35.2%
Pre-Tax Cash Flow/Total Income	16.9%	32.4%

*** Differences between Los Angeles and Non-Los Angeles ratio is significant at the 99% confidence level.

EXHIBIT 3-10

BREAKDOWN OF AVERAGE INCOME AND EXPENSES PER UNIT BY BUILDING AND LANDLORD TYPE: 1983 LOS ANGELES

	<u>Gross Income</u>	<u>Total O&M Costs</u>	<u>Net Operating Income</u>	<u>Total Financing Costs</u>	<u>Pre-Tax Cash Flow</u>
Building Size					
< 6 (n=115)	\$3,010	\$1,210	\$1,799	\$ 993	\$ 776
6-11 (n=54)	\$3,294	\$1,339	\$1,956	\$1,384	\$ 608
12+ (n=40)	\$3,365	\$1,518	\$1,847	\$1,316	\$ 499
Utility Inclusion ¹					
Tenants Pay (n=184)	\$3,420	\$1,410	\$2,010	\$1,391	\$ 588
Landlords Pay (n=24)	\$2,941	\$1,436	\$1,505	\$1,048	\$ 480
Date of Purchase					
Before 1978 (n=148)	\$3,113	\$1,229	\$1,884	\$ 752	\$1,106
After 1978 (n=60)	\$3,460	\$1,670	\$1,789	\$1,901	-\$ 119
Residence of Owner					
Owner Lives on Property (n=51)	\$2,712	\$1,079	\$1,633	\$1,471	\$ 271
Owner Lives Elsewhere (n=157)	\$3,342	\$1,468	\$1,874	\$1,246	\$ 589
Number of Units Owned By Landlord					
Under 5 (n=71)	\$3,064	\$1,265	\$1,799	\$1,069	\$ 670
5-14 Units (n=78)	\$3,041	\$1,279	\$1,761	\$1,347	\$ 403
Over 15 Units (n=59)	\$3,373	\$1,493	\$1,880	\$1,275	\$ 587

1. If the landlord pays for all the gas and/or all the electricity, the building has been designated "master-metered".

EXHIBIT 3-10

(Continued)

	<u>Gross Income</u>	<u>Total O&M Costs</u>	<u>Net Operating Income</u>	<u>Total Financing Costs</u>	<u>Pre-Tax Cash Flow</u>
LMPA ²					
One (n=15)	\$3,045	\$1,435	\$1,610	\$1,341	\$ 269
Two (n=42)	\$2,702	\$1,288	\$1,414	\$ 931	\$ 506
Three (n=61)	\$2,945	\$1,240	\$1,705	\$1,058	\$ 658
Four (n=38)	\$3,785	\$1,613	\$2,172	\$1,959	\$ 200
Five (n=28)	\$4,502	\$1,690	\$2,812	\$1,903	\$ 924
Six (n=6)	(3,351	\$1,502	\$1,850	\$ 999	\$ 851

2. LMPA was missing in 18 cases.

in smaller properties, making their pre-tax cash flow relatively high. However, due to the relatively large standard errors in the estimated means, neither difference proved to be statistically significant at a 90% level of confidence.

Only a small number of landlords (24) reported that they paid the entire gas and/or electrical bill for the property, confirming the finding in the tenant survey that most tenants pay at least part of their utilities outside their rents. The buildings where the landlord did pay all utilities tended to be relatively large and contain an above-average concentration of efficiency units. Although unit operating and maintenance costs were the same regardless of utility arrangements, gross income -- and, hence, NOI -- was significantly lower in master-metered buildings. However, since their unit financing costs also tended to be low, the differences in pre-tax cash flow associated with inclusion of utilities in the rent payment were less pronounced (and, indeed, were not statistically significant).

Some of the most noticeable differences in financial circumstances appear when the data are stratified by the date the property was purchased. Buildings bought after the date when rent stabilization was enacted registered higher incomes, higher expenses, and somewhat lower NOIs. However, only the difference in operating expenses is statistically significant. More important, the financing costs of recent purchasers were more than two-and-one-half times as high as the financing costs of landlords who bought their properties before the dramatic rise in interest rates that occurred in the early 1980s. Because of these high interest rates, recent purchasers reported a net pre-tax cash loss of about \$119 per unit, compared to a net pre-tax gain of about \$1,106 for longer-term owners. Both the cost difference and the net income difference are statistically significant at a 99% confidence level.

Building finances also varied by the characteristics of the property owner. If the owner lived on-site -- a phenomenon that largely occurs in smaller buildings -- the income and expenses associated with rental units were significantly below the aver-

ages reported for other properties. A lower NOI for units in owner-occupied properties, combined with somewhat higher financing costs, also led to a lower average pre-tax cash flow. However, the differences in average NOI, financing costs, and pre-tax cash flow are not statistically significant.

When the data are stratified by the number of units that the landlord owns, both building income and operating costs appear to rise with the size of the landlord's holdings (although only the difference in cost is statistically significant). However, patterns in NOI, financing costs, and pre-tax cash flow do not reveal any systematic tendency for large-scale (or small-scale owners) to make higher profits. On the one hand, average NOI tended to be higher for landlords owning more than 15 units. On the other hand, due to their lower financing costs, landlords with fewer than five units reported the highest average pre-tax cash flow. Neither difference is statistically significant.

Finally, building finances also vary by geographic area, although the small sample size in some LMPAs make the statistics for these areas doubtful. LMPA #5 reported the highest per unit income, expenses, NOI, and pre-tax cash flow. As we found in the analysis of tenant benefits, renters in this area appear to be paying more than they would in the absence of rent stabilization. At the other extreme, LMPAs #1 and 2 indicated the lowest per-unit NOI and pre-tax cash flow. As we saw in the tenant analysis, renters in these areas receive large positive benefits as a result of rent stabilization. The presence of net tenant benefits from rent stabilization need not be associated with a relatively low NOI (although it does imply that NOI would be higher in the absence of stabilization). Conversely, tenants could be paying near-free market rents and building financial performance might still be poor. The latter seemed to characterize LMPA #3, where net tenant benefits and net operating income were both relatively low.

Exhibit 3-11 presents information on the ratios of operating costs, financing costs, and pre-tax cash flow to total building income, each broken down by the same basic landlord and building

EXHIBIT 3-11

FINANCIAL RATIOS BY BUILDING AND LANDLORD TYPE: 1983 LOS ANGELES

	<u>Operating Costs/Income</u>	<u>Financing Costs/Income</u>	<u>Cash Flow/Income</u>
Building Size			
< 6 (n=115)	40%	39%	26%
6-11 (n=54)	41%	42%	18%
12+ (n=40)	45%	39%	15%
Utility Inclusion ¹			
Tenants Pay (n=184)	41%	41%	17%
Landlords Pay (n=24)	49%	36%	16%
Date of Purchase			
Before 1978 (n=148)	39%	24%	36%
After 1978 (n=60)	48%	55%	-6%
Residence of Owner			
Owner Lives on Property (n=51)	40%	54%	10%
Owner Lives Elsewhere (n=157)	44%	37%	18%
Number of Units Owned By Landlord			
Under 5 (n=71)	41%	35%	22%
5-14 Units (n=78)	42%	44%	13%
Over 15 Units (n=59)	44%	38%	17%

1. If the landlord pays for all the gas and/or all the electricity, the building has been designated "master-metered".

EXHIBIT 3-11

(Continued)

	<u>Operating Costs/Income</u>	<u>Financing Costs/Income</u>	<u>Cash Flow/Income</u>
LMPA ²			
One (=15)	47%	44%	09%
Two (n=42)	48%	34%	19%
Three (n=61)	42%	36%	22%
Four (n=38)	43%	52%	05%
Five (n=28)	38%	42%	21%
Six (n=6)	45%	30%	25%

2. LMPA was missing in 18 cases.

types that appeared in the previous Exhibit. In general, the operating costs-to-income ratio ranged from about 38% to 48%, with a relatively low value for smaller buildings and a relatively high value for master-metered buildings and buildings purchased after 1978. The share of financing costs ranged from about 24% to 55%, with buildings purchased after 1978 and owner-occupied buildings showing the highest average ratios. Finally, the ratio of pre-tax cash flow to building income was negative for recent purchasers, and ranged from 10% to 36% for the other subgroups. The highest ratio was observed for buildings purchased before 1978 (which had relatively low financing costs), while the lowest ratios were found among owner-occupied properties and those in LMPA #4 (which reported relatively high financing costs) and in LMPA #1.

3.2.3 Changes in Income and Expenses, 1977-1983

In addition to providing 1983 data, landlords who had owned their buildings since the enactment of rent stabilization were asked for comparable information on their building's finances in 1977. Exhibit 3-12 presents these data for the 88 Los Angeles landlords who provided information for both years. All figures are in nominal dollars and expressed on a per-unit basis. Due to limitations in sample size, we have collapsed "middle-sized" and "larger" buildings into one category consisting of properties with six or more units.

The responses suggest that between 1977 and 1983 gross building income rose by about 66%, or by about 8.8% per year. In contrast, reported operating costs increased by only about 36%. This led to a 94% increase in NOI, from about \$980 per unit in 1977 to about \$1,900 in 1983. Over the same period of time, reported financing costs declined by 11%, generating a large increase in the pre-tax cash flow, from about \$79 in 1977 to \$1,113 in 1983. While operating costs rose less rapidly in smaller buildings than in larger ones, financing costs tended to rise a bit faster. As a result, reported trends in pre-tax cash flow are about the same regardless of building size.

EXHIBIT 3-12

1977-1983 TRENDS IN INCOME AND EXPENDITURES
PER UNIT: LOS ANGELES ONLY

	<u>1977</u>	<u>1983</u>	<u>% Change</u>
All Buildings (n=89)			
Gross Income	\$1923	\$3184	+ 66%
O&M Expenditures	943	1283	+ 36%
Net Operating Income	980	1900	+ 94%
Financing Expenses	908	806	- 11%
Pre-Tax Cash Flow	79	1113	+1309%
Small Buildings (<5 Units) (n=54)			
Gross Income	1858	2992	+ 61%
O&M Expenditures	1011	1219	+ 21%
Net Operating Income	847	1773	+ 109%
Financing Expenses	784	651	- 17%
Pre-Tax Cash Flow	78	1156	+1382%
Larger Buildings (6+ Units) (n=35)			
Gross Income	1949	3256	+ 67%
O&M Expenditures	917	1314	+ 43%
Net Operating Income	1032	1942	+ 88%
Financing Expenses	973	879	- 10%
Pre-Tax Cash Flow	82	1092	+1232%

The relatively low rate of increase in operating costs principally reflects a decline in property taxes that resulted from voter approval of Proposition 13 in 1978. Exhibit 3-13 presents a breakdown of operating costs into seven major components, including: payroll, expenses, utilities, management fees, parts and supplies, contracted maintenance, taxes and fees, and property insurance. It is evident that the components of building costs other than taxes increased at a rate that far exceeded the increase in building income. The highest increase was observed for salaries, utilities, and management fees. The lowest rate of increase was registered by contracted maintenance and insurance. However, even these cost components increased at a rate that was significantly above the increase in average income. By contrast to these trends in all other cost categories, property taxes declined by 45%, from an average of \$339 per unit in 1977 to about \$186 in 1983. As a result of this decrease, the share that property taxes made up in total operating costs fell from 38% to 15%.

This highly significant shift underlay the relatively low rate of growth observed in operating and maintenance costs and the above average increase observed in NOI. If property taxes had risen by 2% per year -- the maximum now allowed under Proposition 13 for properties that do not change ownership -- total operating costs would have increased by about 64% and average net operating income by about 67%. If taxes had increased at the same rate as building income, total operating costs would have risen by about 84% and net operating income by about 48%.

It should be noted that the observed increase in NOI (94%) experienced by these landlords who held their property throughout the rent stabilized period is considerably above the maximum that would qualify for a hardship increase under the city's "just and reasonable" exception guidelines. Under the Just and Reasonable (J&R) procedure, landlords are entitled to maintain the same level of net operating income that they received prior to stabilization, adjusted upwards by 7% per year.⁸ In general, the permitted rent adjustments plus the property tax savings resul-

EXHIBIT 3-13

TRENDS IN THE COMPONENTS OF OPERATING COSTS: 1977-1983

	<u>1977</u>	<u>1983</u>	<u>% Change</u>
Salaries	\$ 62 (14)	\$125 (26)	+102%
Utilities	\$154 (14)	\$336 (30)	+118%
Management & Administration	\$ 36 (6)	\$ 88 (14)	+144%
Parts & Supplies	\$ 52 (7)	\$100 (15)	+92%
Contract Maintenance	\$193 (24)	\$330 (32)	+71%
Taxes & Fees	\$341 (29)	\$188 (10)	-45%
Insurance	\$ 61 (6)	\$110 (9)	+80%

ting from Proposition 13, were expected to maintain this level of NOI for the majority of the City's without the need for a J&R exception. In fact, these data indicate that between 1977 and 1983, average NOI for these landlords increased by 94%, up to about \$1,900 per unit. By comparison their adjusted NOI, at 7% per year, would have been \$1,400 per unit.

Alternatively, if the J&R guidelines had allowed NOI to increase annually by the amount of the CPI (64% over the period), actual NOI in 1983 would still have been higher, at \$1,900, than the amount (\$1,607) that would have created eligibility for a hardship exception to the ceiling on rent increases. These findings may explain the low number of J&R increase applications that have in fact been received by the City. As of November 1984, 88 such applications over the preceding five years, and only 11 had been granted.

3.2.4 Building Values and Equity Investments

In addition to providing income and expense data, owners were asked to estimate the value of their properties, as well as the amount of their current equity investment. They were also requested to provide information on date of purchase, purchase price, and original down payment. These data are presented in Exhibit 3-14. The first two columns present data for the average property. The next two columns present information for the average unit.

The data received indicate that the average owner of multi-family residential rental property in the Los Angeles area has owned his/her property for roughly 14 years. Within the City, while the average purchase price was about \$136,000, landlords now value their buildings at an average of just over \$282,000. Equity has grown with the appreciation of property values, from an average initial investment of about \$37,000 to more than \$190,000 today. The average share of equity has thus increased from about 19% of the property's value to over 71%. Net operating

EXHIBIT 3-14

PROPERTY VALUES AND EQUITY INVESTMENTS
INSIDE AND OUTSIDE LOS ANGELES

	<u>Properties</u>		<u>Units</u>	
	<u>Inside</u>	<u>Outside</u>	<u>Inside</u>	<u>Outside</u>
Length of Ownership (Years)	14.6	14.4	13.1	14.0
Property Value				
Current	\$282,350	\$450,872	\$35,054	\$51,108
Purchase Price	\$135,971	\$170,043	\$16,821	\$19,334
Equity Investment				
Current	\$190,540	\$344,878	23,341	38,477
Initial	\$36,518	46,134	4,054	5,296
Ratio of Equity to Value				
Current	0.71	0.69	0.69	0.75
At Purchase	0.27	0.27	0.24	0.31
Ratio of Average NOI to Average Value	0.060	0.064	0.053	0.064

income represents about 5%-6% of current value. Viewed another way, the capitalization rate is roughly 17%, which is similar to the estimate derived from our analysis of real estate sales.

In the unstabilized areas outside the City, estimated property values were considerably higher, averaging over \$450,000. Similarly, initial purchase price, original down payment, and estimated current equity were all considerably higher than in the Los Angeles sample. However, the ratio of net operating income to current value -- or, put another way, the estimated capitalization rate -- was reported as about the same as the ratio observed in the City. This suggests that property owners inside and outside the city are applying the same basic discount rate to their estimated revenue streams.

Patterns are much the same when the data are expressed on a unit basis. Los Angeles landlords estimate their buildings to be worth an average of about \$35,000 a unit, with an invested equity of over \$23,000. Estimated property values have doubled since the purchase date and invested equity has increased by almost six-fold. The ratio of NOI to current value for the average unit in the Los Angeles sample is about 5.3 percent. This ratio is smaller than the one derived for the average property, since the capitalization rate is apparently lower in smaller buildings.

These data differ somewhat different from the DAMAR property sales data employed earlier in this Chapter to calculate historical rates of return. The average per-unit sales price for 1983 (DAMAR) was about 10% higher than the estimated current value obtained from the landlord survey for properties inside Los Angeles (\$38,500 in the DAMAR data, compared to \$35,000 in the landlord survey). Outside the City, on the other hand, the reverse relation obtained, with landlords' value estimates exceeding by almost 15% the average per-unit sales price reported (\$44,000 DAMAR versus \$51,000 in the landlord survey). Thus, the landlords in the survey appear to underestimate current property values slightly inside Los Angeles while overestimating them outside the

City.⁹ Whether these perceptions had anything to do with the presence or absence of rent stabilization cannot be discerned from the survey results.

Turning to a comparison of rates of simple pre-tax return reported in the landlord survey as against those derived from the DAMAR property sales data, 1983 pre-tax returns on the value of in-City properties averaged about 16% (including appreciation) based on the landlord survey and about 15% based on the DAMAR sample. For properties outside the City, the corresponding returns both averaged 15%.¹⁰ Thus, the landlord survey data confirm our earlier finding that Los Angeles properties are no longer generating returns significantly below those being realized in surrounding, unstabilized jurisdictions.

3.2.5 Mortgage Financing Arrangement

A final section of the landlord survey asked owners to provide a detailed description of the nature and amount of mortgage financing that was currently applicable to their properties. The resulting data on rent stabilized properties within the City of Los Angeles are summarized in Exhibit 3-15. The first column presents statistics for the average property. The second column presents comparable information expressed on a per-unit basis.

The data suggest that one-third of all rent stabilized properties -- containing 20% of all stabilized units -- are owned by the landlord free and clear. The average landlord in this category purchased his/her property in 1960 and has since paid off the original loan that financed that purchase. However, 50% of all properties (and 64% of all units) have one outstanding mortgage, while the remaining 17% of all properties (and 16% of units) have two or more mortgage loans outstanding. About 56% of the buildings with multiple mortgages were purchased after 1977.

The respondents reported that the terms of the first mortgages are generally more favorable than the terms of seconds. For example, the average first mortgage had an interest rate of 10.21%, compared to 10.93% for second mortgages. The majority of first mortgages were fixed rate, self-amortizing loans, with an

EXHIBIT 3-15

MORTGAGE CHARACTERISTICS
(Los Angeles Only)

	<u>Properties</u>	<u>Units</u>
<u>DISTRIBUTION BY NUMBER OF MORTGAGES</u>		
No Outstanding Mortgages (n=63)	33%	20%
One Outstanding Mortgage (n=95)	50%	64%
Two or More Outstanding Mortgages (n=32)	17%	16%
<u>CHARACTERISTICS OF PRIMARY MORTGAGES</u>		
Average Interest Rate	10.21%	10.05%
Average Term	16.3 yrs.	16.6 yrs.
Average Years to Maturity	6.1 yrs.	6.1 yrs.
Mortgage Type:		
% Balloon	15%	17%
% Fixed-Rate	76%	71%
Percent That Replaced a Previous Mortgage	22%	21%
<u>CHARACTERISTICS OF SECOND MORTGAGE</u>		
Average Interest Rate	10.93%	9.79%
Average Term	8.6 yrs.	9.3 yrs.
Average Years to Maturity	4.8 yrs.	6.1 yrs.
Mortgage Type:		
% Balloon	56%	39%
% Fixed-Rate	82%	77%
Percent That Replaced a Previous Mortgage	39%	51%

average term of 16 years. While the majority of second mortgages were also fixed rate loans, 56% involved balloon obligations at maturity and the average term was considerably shorter (about nine years). The average first and second mortgage were both scheduled to mature in about 1990.

The great majority of current first mortgages on rent stabilized properties (78%) were initiated at the time that the building was acquired. Only 22% of all responding landlords indicated that their current mortgage had replaced a previous loan. The 24 landlords who did report that they had refinanced their properties were asked to break down the way that they had used the proceeds from their current loan. According to their estimates, 55% of the proceeds was used to pay off the remaining balance on their previous loans, 16% was used to finance capital improvements, and 29% was used to raise cash for other purposes.

The same question was asked of the 32 landlords who reported having a second mortgage. In this instance, a greater proportion (39%) indicated that their current second had replaced a previous loan. Twenty-seven percent of the proceeds from refinancing were used to pay off a previous second, 17% to fund capital improvements, and 24% to raise cash for other purposes.

It should be noted that landlords who own their properties free and clear, or have fixed rate, self-amortizing primary mortgages, which categories seem to include the majority of Los Angeles property owners, are best positioned to operate within a rent adjustment formula which allows for a fixed contribution for principal and interest. Landlords with balloon or variable rate mortgages, on the other hand, would be likely to have more volatile financing costs. According to the survey results, properties with these more variable financing costs represent about 28% of the stabilized housing stock.

3.2.6 Comparison of Landlord Survey Data to Other Data Sets

As noted at the outset, we have compared the data collected through the landlord survey to similar information available from other sources. As noted earlier, the gross per-unit incomes re-

ported by Los Angeles landlords (which average about \$272 per month) are considerably below the average contract rents reported in the tenant survey (about \$408 per month). Part of this difference may reflect income losses due to vacancies and a difference of one to two years in the period being reported upon by tenants, on the one hand, and landlords on the other. We attempted to adjust for these factors by assuming an 8.8% inflation rate and a 6.1% difference between actual and potential income.¹¹ However, the resulting adjusted income figures (which averaged about \$314 per unit per month) remain considerably below the data supplied by tenants.

In contrast to the data received from City landlords, the per-unit incomes reported by non-Los Angeles landlords (which averaged about \$404 per month) were relatively close to the rent figures reported by tenants (\$422 per month, on the average) who live in unstabilized contiguous cities. Nothing in the survey data permits us to account for the difference between landlord and tenant reports within the City of Los Angeles, but we are able to compare the survey results with other data sets in order to assess the plausibility of the survey outcomes.

DAMAR and IREM Data. The survey data have been compared to two secondary data sets: (1) the DAMAR data (which were used in the rate of return analysis presented at the outset of this Chapter); and (2) statistics compiled by the Institute for Real Estate Management (IREM), which collects annual information on the income and expenses of large (i.e. 12+ unit) properties in the Los Angeles metropolitan area. Exhibit 3-16 displays the basic income and operating expense information in each of these data sets for the year 1983, along with analogous information derived from the landlord survey. To facilitate comparison, we have weighted the averages which were obtained in the landlord survey for properties inside and outside of Los Angeles by their proportionate share in the total rental stock in the metropolitan area. These weighted averages should thus reflect a geographic distribution roughly comparable to the IREM sample.

EXHIBIT 3-16

A COMPARISON OF THE 1983 IREM AND SURVEY DATA

	<u>DAMAR DATA</u>		<u>IREM DATA¹</u>			<u>SURVEY DATA</u>		
	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>	<u>SMSA</u>	<u>All Buildings</u>	<u>Garden Apartments (Low)</u>	<u>Inside Los Angeles</u>	<u>Outside Los Angeles</u>	<u>Combined²</u>
Gross Income per Unit	\$4,642	\$4,878	\$4,848	\$4,848	\$4,198	\$3,262	\$4,853	\$4,089
Operating Costs per Unit	\$1,751	\$1,908	\$1,830	\$1,830	\$1,557	\$1,418	\$1,591	\$1,508
Net Operating Income per Unit	\$2,891	\$2,970	\$2,941	\$2,941	\$2,048	\$1,843	\$3,262	\$2,581
Ratio of Operating Costs to Income	0.38	0.39	0.38	0.38	0.371	0.43	0.33	0.37
<hr/>								
Number of Properties				241	70	208	43	
Number of Units				11,892	5,442	1,908	381	

1. The IREM data presents the medium square foot income and costs for each of four different building categories. The figures in the chart were derived by multiplying the reported income (or cost) per square foot in a given category by the total number of square feet in that category, summing across the four building types, and then dividing through by the total number of apartment units.
2. Combined statistics for the survey data were derived by weighting the Los Angeles and non-Los Angeles averages by the proportion of the SMSA's total rental units that are inside and outside the city, respectively.

The Exhibit shows that, according to the DAMAR figures, Los Angeles properties that were sold in 1983 had an average income of \$4,642, average costs of \$1,751, and an average expense-to-income ratio of 38%. Although both income and costs were reported as marginally higher for properties located outside the City, the expense-to-income ratio was about the same. The Exhibit further indicates that the DAMAR figures for average incomes outside the City are virtually identical to those reported in the landlord survey, while DAMAR-reported incomes within the City are some 40% higher than the survey suggests, and considerably closer to the average monthly rents derived from the tenant survey. On the other hand, average operating costs are significantly higher in the DAMAR data than in the landlord survey results, both inside and outside the City. As a result, the DAMAR data yield an estimated operating expense-to-income ratio that is below that (43%) based on the survey for Los Angeles properties, but considerably above the survey-based ratio (33%) for unstabilized areas contiguous to the City.

The IREM data yield results that are roughly comparable to the DAMAR data, but again, somewhat different from the landlord survey results. The Exhibit shows that in 1983 IREM reported an average income of \$4,848 per unit, average expenses \$1,830 and an average expense-to-income ratio of 38%, which was identical to the ratio derived by DAMAR for properties inside the City of Los Angeles. The lowest incomes and operating costs were observed in the IREM data among garden apartments, which may be more comparable to the types of buildings that are generally covered by rent stabilization than is the metropolitan rental housing stock as a whole. The bottom quarter of this garden apartment group reported an average income of \$4,198, average costs of \$1,557, and an expense-to-income ratio of 37%. The operating costs that were reported in the landlord survey were considerably below the medium costs reported by IREM, but fairly similar to the lower range reported for garden apartments.

The Exhibit shows that the operating expense-to-income ratios derived from the survey data tend to bracket the ratios based on IREM data, with a higher survey-based ratio in the City and a lower ratio in surrounding areas. Because of this bracketing effect, despite the fact that the ratio derived from the survey for the City was much lower than the corresponding ratio based on IREM data, the combined survey average -- which was obtained by weighting the averages inside and outside the City by each area's share of the rental stock -- is about the same if one uses either the survey or the IREM file as a data base.

Exhibit 3-17 compares the income and expense trends reported in the IREM data with those observed in the survey data. Note, however, that the IREM data do not refer to the same set of buildings in each whereas the survey data are restricted to the set of landlords who reported both 1977 and 1983 data. Also, due to limitations in sample size, the survey data can only be presented for the City of Los Angeles.

Despite these differences, some similar trends are revealed. Unit income, expenses and NOI again tend to be higher in the IREM data. They also show a more rapid rate of growth over the six-year period. However, in both data sets, income rises more rapidly than operating costs, producing a marked decline in the ratio of operating costs to income. Examination of the underlying cost components reported in IREM again reveals the significant decline in property taxes resulting from Proposition 13, from about \$355 per unit in 1977 to about \$214 per unit in 1983. The same factor was at work in the survey data.

California Franchise Tax Board Data. More direct comparisons can be made between the survey results and data on rent-stabilized properties in the City obtained from the State Franchise Tax Board (FTB). As part of this study, the City Rent Stabilization Division (RSD) requested a special match of properties currently registered with the Division and income tax data on file with the FTB. While maintaining strict confidentiality with respect to all individuals and individual properties, the FTB was able to

EXHIBIT 3-17

COMPARISON OF SURVEY DATA WITH
1977-83 TRENDS IN IREM

	IREM			Survey Data (Los Angeles Only)		
	1977	1983	%	1977	1983	%
Gross Income/Unit	\$2,531	\$4,848	+92%	\$1,923	\$3,184	+66%
Operating Costs/Unit	\$1,144	\$1,830	+60%	\$ 943	\$1,283	+36%
Net Operating Income/Unit	\$1,360	\$2,941	116%	\$ 980	\$1,900	+94%
Ratio of Operating Costs to Income	45%	38%	---	49%	40%	---

provide averages for groups of ten or more returns. This provided average income and cost data for a total of 3,765 properties, broken down by building size and LMPA. All of these properties are rent-stabilized. However, since the data were generated from individual tax returns, all corporation property owners and most real estate partnerships were necessarily absent from the sample.

Exhibit 3-18 compares the distribution of the FTB data by building size and LMPA to the distribution of the landlord survey and the universe of rent-stabilized properties. It demonstrates that the distribution of the FTB data by building size is relatively close to the overall profile of the universe. However, the distribution of the sample by LMPA is not a very good match to the geographic distribution of all stabilized apartments. While this would not affect statistics for individual LMPAs, it might affect the findings for the sample as a whole. To avoid this danger, we reweighted the data for each building class in each LMPA to reflect its actual share in the universe of stabilized apartments. Having done this, the likelihood of a bias appears to be small.

Exhibit 3-19 compares the data obtained from the FTB sample with those derived from the landlord survey. Since information on the aggregate number of units covered by the FTB sample is not available, all statistics refer to per-property, not per-unit averages. Note also that the data on financing costs differ as between the samples. The FTB data refer only to interest expenditures. However, the majority of respondents in the landlord survey were unable to break down their mortgage payments into interest and principal. As a result, holding all other factors constant, reported financing costs in the landlord survey should be higher than in the FTB sample.

The Exhibit shows that the reported average income and operating expenses for all buildings combined did in fact tend to be somewhat higher in the survey data than in the FTB sample. However, the overall ratios of operating costs to income were about the same: 41% in the FTB sample and 43% in the landlord

EXHIBIT 3-18

CHARACTERISTICS OF THE FTB DATA

	<u>FTB Sample</u>	<u>Landlord Survey</u>	<u>All Rent Controlled Properties</u>
Distribution of Properties by Number of Units			
Under 6	56%	55%	60%
6-11	30%	26%	24%
Over 11	15%	19%	17%
Distribution of Properties by LMPA			
#1	6%	8%	10%
#2	17%	22%	25%
#3	49%	32%	28%
#4	9%	20%	17%
#5	17%	15%	15%
#6	7%	3%	6%

EXHIBIT 3-19

COMPARISON OF FTB AND LANDLORD SURVEY EXPENSE AND INCOME DATA

	Ave. Income Per Property	Ave. Operating Costs Per Property	Ave. Net Operating Income Per Property	Ave. Financial Expenses Per Property	Ave. Pre-Tax Cash Flow	Operating Costs : Income	Pre-Tax Cash Flow : Income
<u>All Buildings</u>							
FTB Sample	\$24,892	\$10,271	\$14,620	\$8,622	\$5,998	41%	24%
Landlord Survey	29,840	12,977	16,863	11,841	5,123	43%	17%
<u>2 to 5 Units</u>							
FTB Sample	8,942	3,971	4,971	3,155	1,816	44%	20%
Landlord Survey	9,319	3,748	5,571	3,056	2,389	40%	25%
<u>6-11 Units</u>							
FTB Sample	25,602	10,360	15,243	6,900	8,343	40%	33%
Landlord Survey	23,230	9,577	13,653	10,057	3,697	40%	16%
<u>12+ Units</u>							
FTB Sample	78,533	30,890	47,643	29,199	18,445	40%	23%
Landlord Survey	97,248	43,870	53,378	38,232	14,483	45%	15%
<u>LMPA #1</u>							
FTB (n=209)	9,610	4,459	5,150	2,722	2,428	46%	25%
LL (n=15)	17,052	8,038	9,014	7,509	1,504	47%	8%
<u>LMPA #2</u>							
FTB (n=649)	13,219	6,861	6,358	5,126	1,232	52%	9%
LL (n=42)	14,605	6,963	7,641	5,105	2,775	48%	19%
<u>LMPA #3</u>							
FTB (n=1608)	26,057	11,120	14,937	8,186	6,751	43%	26%
LL (n=61)	27,374	11,528	15,846	9,992	6,215	42%	23%
<u>LMPA #4</u>							
FTB (n=332)	43,653	16,765	26,888	16,023	10,865	38%	25%
LL (n=38)	42,133	17,953	24,180	22,583	2,306	43%	5%
<u>LMPA #5</u>							
FTB (n=638)	36,280	12,952	23,328	12,021	11,308	36%	31%
LL (n=28)	27,980	10,505	17,475	12,298	5,969	38%	21%
<u>LMPA #6</u>							
FTB (n=194)	17,904	7,278	10,626	6,901	3,725	41%	21%
LL (n=6)	22,902	10,263	12,639	6,823	5,815	45%	25%

survey. While the aggregate nature of the FTB data do not enable one to calculate confidence intervals, the standard error of the estimated operating cost-to-income ratio in the landlord survey is about 2%. Thus, the difference between the two averages, which is also 2%, is not statistically significant. By contrast, the ratio of cash flow to building income is significantly higher in the FTB data than in the survey results. This presumably reflects the fact that financing costs in the landlord survey include both interest and principal payments, rather than interest only.

Patterns in average income and operating costs are also fairly comparable across LMPAs. While the precise levels differ, the estimated averages typically move together. Thus, according to both data sets, LMPA #5 -- West Los Angeles -- registered the lowest operating expense-to-income ratio. As noted in a previous section, this area reported the highest overall income when expressed on a unit basis. On the other hand, both data sets reveal above-average expense-to-income ratios in LMPAs #1 and #2. These areas were characterized by below-average net operating incomes and, in the analysis reported in Chapter 2, by relatively high net tenant savings from rent stabilization.

The patterns observed in the FTB and survey data are less consistent when one stratifies by building size. While the expense-to-income ratios were about the same for buildings with 6-11 units, ratios for larger and smaller buildings were somewhat different. In the landlord survey, the highest average expense-to-income ratio was observed among larger buildings. In the FTB data, this pattern was reversed. In the absence of additional data, it is difficult to interpret these patterns. However, they may reflect differences in the types of landlords covered in either survey. Again, while we cannot develop standard errors for the FTB estimates, the standard errors of the operating expense-to-income ratios in the landlord survey were about 2% for buildings with less than 6 units and 3% for buildings with more than 11 units. Thus, the differences observed between expense-to-income ratios could be statistically significant.

3.3 Summary of Probable Impact

Synthesizing the variety of complex data sets that have been analyzed in this Chapter to arrive at an overall assessment of the probable impact of rent stabilization on the owners of multi-family residential rental property in Los Angeles is a necessarily imprecise exercise. Part of the problem reflects the fact that the various data sets considered pertain to samples that may differ in unknown ways. The SREA and DAMAR data refer only to properties that have been sold; the IREM data pertain only to larger-scale properties located throughout the metropolitan area; the FTB data refer only to rent-stabilized properties owned by individuals, not by corporations or most forms of partnership; and the data from the special landlord survey refers to properties whose attributes may not accurately reflect the underlying universe. Because of these differences, some of the information acquired from these sources can (and does) vary significantly.

Yet, despite these difficulties, some broad conclusions do emerge. First, although the precise numbers differ depending on the measure of return on investment that is employed, the data suggest that the adverse effects of rent stabilization on annual rates of return was largely confined to the first few years of implementation of the program, and that current returns in Los Angeles are as high (if not higher) than those in surrounding unstabilized areas.

Second, the analysis indicates that the net loss to the City's landlords as a result of rent stabilization has been relatively small to date, if one considers the entire period 1977-83. Los Angeles landlords who sold their properties immediately following the enactment of stabilization did receive a significantly lower rate of return than their counterparts in unstabilized areas. However, property values in the City have rebounded from the slump they suffered in the first few years of stabilization. Average rates of return over the entire post-stabilization period are still below the levels that have been generated in surroun-

ding areas, but, because of the recent resurgence in the Los Angeles market -- coupled with an apparent lull in surrounding areas -- the differential is small and shrinking rapidly. This finding is quite consistent with our earlier analysis of the financial benefits of stabilization to all tenants taken together, which found that, under the same set of market assumptions, these savings were positive but modest. The findings of this Chapter confirm that the flow of subsidy from all landlords to all tenants, both groups taken as a whole, is now relatively small.

Third, operating costs appear to absorb a larger fraction of building income in the City of Los Angeles than they do in surrounding, unstabilized areas. Although the sample of unstabilized properties is relatively small, the survey data suggest that operating expense-to-income ratios are almost 10% lower outside the City, and the general level of these ratios in stabilized properties seems to be confirmed by the FTB data. While the size of the differential between the City and surrounding areas may be overstated in the survey results, metropolitan-wide data from IREM are consistent with lower expense ratios outside the City. This finding is also consistent with those reported in Chapter 2. If tenants pay below-average rents as a result of stabilization, operating expenses will comprise a larger share of landlord income.

Nevertheless, as a fourth major finding, the data suggest that, assessed by most objective criteria, the majority of stabilized properties seem to be in relatively good financial shape. While average rates of return on stabilized properties have until recently been below those in unstabilized areas, returns in the City have been unfailingly positive, on the average. Similarly, while operating expense-to-income ratios in the City appear to be higher than in surrounding areas, they are still somewhat below the national averages, as reported by IREM (which range 44%-47%). Only a few properties report operating losses and, while a much higher fraction report a negative cash flow because of financing costs, the majority of these properties were purchased after

1978. Thus, landlords who acquired their properties prior to the implementation of rent stabilization -- and who, presumably, had the most to lose -- appear to be in relatively sound overall financial condition.

It must be emphasized that the financial position of the City's landlords would have been quite different in the absence of Proposition 13. Between 1978 and 1983, average property tax per unit fell by about 45% in the City, compared to an estimated 95% increase in the other components of operating costs. As a result, overall operating and maintenance costs increased by only 36% per year in the stabilized stock, and the ratio of operating costs to income declined from 49% to 40%.

Finally, in reviewing these findings it is important to recognize that returns on real estate investments varied enormously from year to year and were affected by a wide variety of economic and social factors in addition to rent stabilization and Proposition 13. Prominent among these were the runaway price inflation associated with the second world oil shock in 1979, the skyrocketing interest rates that characterized the earlier part of this decade, and the major revisions in Federal tax law that were enacted in 1981.

Moreover, it may well be that the enactment of rent stabilization in Los Angeles had some effects on financial realities in surrounding jurisdictions because of fear among property owners that the policy would spread to their jurisdictions. If this perceived threat tended to depress appreciation of property values and, thereby, rates of return in these areas, than a comparative analysis may understate the actual impact on the program of both in-City and outside landlords. No analysis can take such possibilities perfectly into account. But the reader should bear them in mind in interpreting the data and analysis presented herein.

1Note that for the years 1970-76 data on operating expenses were not available for individual properties. Data for those years procured from the Institute of Real Estate Management (IREM) were used to estimate operating expenses as a percentage of revenues.

These percentages are as follows: 1970-51%, 1971-52%, 1972-51%, 1973-49%, 1974-53%, 1975-51%, and 1976-53%. In addition, no revenue data were available for properties sold during the year 1975. Therefore, we interpolated the 1975 revenue estimates using the data for 1974 and 1976.

²Given annual estimates of value (V_t), revenue (R_t), and operating costs (OC_t), the current year's pre-tax return on value (r_t) is calculated as:

$$r_t = (R_t - OC_t + (V_{t+1} - V_t)) / V_t$$

³The estimated differences between rates of return inside and outside the City of Los Angeles test out as statistically significant for the years 1976-81 and for 1983. The absence of statistical significance in 1982 and in some of the years prior to 1976, when the differences appear to have been at least as large, is probably due to smaller sample size.

⁴All rate of return simulations presented in the body of this Chapter are based on the "high" tax rate assumptions among the assortment of such assumptions described in Appendix G. Results for the "low" and "moderate" tax assumptions are shown in that Appendix.

⁵After-tax return on value incorporates deductions for depreciation, but not for interest payments. Therefore, tax liabilities are positive for both prototypes in all years.

⁶Roughly one-third of the completed survey responses that were dropped lacked total expense or income data for 1983, without which the analysis could not be performed. The rest either utilized a different bookkeeping period that could not be rendered comparable to the others or contained large numbers of clear inconsistencies that could not be eliminated while leaving the overall response subject to analysis.

⁷Unit averages were derived by weighting the unit costs of every property by the number of units it contained.

⁸To calculate a J&R increase, the City compares 1977 (or base year) NOI, as adjusted upward by 7% per year, with NOI for the current year. If current NOI is greater than adjusted base year NOI, the property is not eligible for a J&R increase. If current NOI is less than adjusted base year NOI, the landlord is eligible for an increase sufficient to raise current NOI to the adjusted base year level.

⁹This assumes that sales prices more accurately reflect market value than do landlord estimates. It is possible, however, that the Los Angeles properties sold during 1983 had above average values, while those sold outside the City had below average values.

¹⁰These rate of return measures use DAMAR estimates of 1982-83 property appreciation rates -- 11% inside Los Angeles and 8.5% in

surrounding jurisdictions.

11The inflation rate was derived by taking the average (compounded) increase reported by landlords between 1977 and 1983. The income lost through vacancies represents the average difference between actual and potential income as reported by the 1983 survey conducted by the Institute of Real Estate Management.

CHAPTER 4

ALTERNATIVE RENT ADJUSTMENT FORMULAS

The two previous Chapters have examined the impact of the present system of rent stabiliation on the city's tenants and apartment owners. This Chapter considers some alternative rent adjustment formulas that we were asked to test, and estimates their impact on landlords, on tenants, and on City tax revenues. We also report the projected effects of two possible modifications of the current system of vacancy decontrol that we were asked to examine. The first modification would extend the rent adjustment guidelines to vacated (as well as continuously occupied) apartments. The second would impose a 10% cap on any increase in the rent charged for a vacated unit at the time of turnover.

The Chapter begins by describing a Price Index of Operating Costs (PIOC) that can be used to relate allowable rent increases to increases in operating and maintenance costs. The second section compares this cost-based Index to a number of alternative rent adjustment formulas, including: (1) the all-item Consumer Price Index (CPI) for the Los Angeles metropolitan area; (2) a fixed proportion of the CPI; (3) the non-shelter component of the CPI; (4) a rate-of-return based formula, tied to mortgage interest rates and the return on tax exempt bonds; and (5) the current ceiling of 7% (plus any applicable allowance for rent-financed utilities) on the annual increase in the rental charged for an unvacated unit. The third section of the Chapter considers modifications to the current system of vacancy decontrol, while the fourth examines a system of differential rent adjustments

designed to gradually reduce current differences in rents among tenants of different lengths of tenure. The final section summarizes the strengths of the formulas tested.

4.1 Constructing An Index of Operating Costs

One of the principal objectives of this study is to develop an index of operating costs that could be used to establish rent adjustment guidelines that compensate Los Angeles landlords for annual increases in building operating and maintenance expenditures. This section summarizes how data obtained from the landlord survey have been used to develop such an Index. (The full technical detail may be found in Appendix H.) The section then compares the Index values derived from the landlord survey to comparable statistics constructed from the IREM and FTB data bases described in the preceding Chapter.

The cost-based Index developed herein requires three different types of data. First, one must have information on the annual changes that occur in the prices of a number of building inputs (e.g., taxes, electricity, wage rates, etc.). Second, one must develop a series of weights that can be used to combine these various price changes into an overall index of operating and maintenance costs. And third, one must estimate an appropriate ratio that can be used to translate changes in operating costs into allowable rent increases. Such a ratio should reflect the share of operating and financing costs in total building income.

We began by using data obtained from the landlord survey to derive the basic parameters of a cost-based rent adjustment formula. Expenditure weights were constructed for the sample as a whole, as well as for a variety of building types defined by size, location (LMPA), and utility inclusion. Sources for measuring annual changes in the price of operating inputs were then identified and the 1984 Index of Operating Costs (PIOC) was

derived. Finally, we compared the expenditure weights and operating costs-to-income ratios that were derived from the landlord survey to comparable statistics constructed from the IREM and the FTB data. Each step will be described in very summary form here.

4.1.1 The Expenditure Weights

Exhibit 4-1 presents the expenditure weights that were derived from the landlord survey. The figures in parentheses represent the standard errors of the estimated weights. The first column in the chart presents weights for the sample as a whole; the next two columns present weights for buildings in which the tenants pay utilities and weights for buildings which are "master-metered." Note that master-metered buildings refer to those in which the landlord pays the entire gas and/or electrical bill. Such properties are currently eligible for an extra 1%-2% rent increase.

The estimated expenditure weights reflect the relative importance of various types of building expenditures in total operating and maintenance costs. The weights were derived by taking the ratio of expenditures in a given category (e.g., taxes) to total building costs. Seven basic components are considered, including (1) salaries and wages; (2) utilities; (3) management and administration; (4) parts and supplies; (5) contracted maintenance; (6) taxes and fees; and (7) property insurance. Utilities are further broken down into expenditures on gas, electricity, and water and sewer.¹

The expenditure categories with the largest weights in the sample as a whole are utilities (0.224), contracted maintenance (0.217), and salaries and wages (0.185). Property taxes represent about 16% of operating costs, while the weights attached to insurance, parts and supplies, and management and administration are between 6.5% and 8%. The share of utilities and salaries is considerably higher in master-metered buildings, where expenditures on gas alone amount to 18% of operating costs. While the weights associated with management and insurance are roughly the

EXHIBIT 4-1

BREAKDOWN OF EXPENDITURE WEIGHTS
BY UTILITY INCLUSION: LOS ANGELES ONLY

	<u>All Buildings</u>	<u>Tenants Pay Utilities</u>	<u>Landlord Pays Utilities</u>
Salaries	0.185	0.132**	0.289**
Utilities	0.224	0.209	0.254
Electricity	0.074	0.084 (.011)	0.059 (.033)
Gas	0.115	0.077	0.181
Water & Sewer	0.034	0.048**	0.013**
Management & Administration	0.075	0.079	0.067
Parts & Supplies	0.065	0.077***	0.040***
Contract Maintenance	0.217	0.248	0.158
Taxes & Fees	0.158	0.174***	0.124***
Insurance	0.078	0.081	0.068

** Figures are statistically significantly different at the 95% level of confidence.

*** Figures are statistically significantly different at the 99% level of confidence.

same, the weights associated with parts and supplies, contracted maintenance, and property taxes are lower in master-metered buildings.

Exhibit 4-2 presents expenditure weights derived for a number of additional property types defined by (1) building size; (2) residence of owner; (3) date of purchase; and (4) LMPA. All data refer to buildings in which the tenants pay utilities. The weights depicted in the Exhibit are the ones employed in subsequent analyses of the impact of the different formulas on various types of property owners. Due to small sample size, comparable breakdowns have not been derived for buildings which are master-metered.

In general, smaller buildings tend to spend proportionately less on salaries, utilities, and administration, and proportionately more on parts and supplies, insurance and property taxes. Salaries also represent a relatively low proportion of expenditures in owner-occupied buildings, while the weights assigned to parts and supplies and insurance are relatively high. Although expenditure weights do not vary dramatically by date of purchase, properties that were acquired since the enactment of rent stabilization tend to spend proportionately more on taxes and management fees, and proportionately less on utilities.

Expenditure weights also appear to vary by LMPA, although the standard errors are often relatively large because of the small sample size in some Areas. The share of property taxes is highest in LMPAs #5 and #4, and lowest in LMPAs #2 and #3, a pattern that mirrors variations in property values. Utilities ranged from 17% to 25% of total building costs; management fees and parts and supplies from 3% to 12%; and property insurance from 6% to 10%. With the exception of LMPA #6 (which had only six properties reporting), the weights associated with salaries and contracted maintenance did not vary significantly by geographic area.

EXHIBIT 4-2

1983 EXPENDITURE WEIGHTS BY BUILDING AND LANDLORD TYPE
(EXCLUDING MASTER-METERED BUILDING)

	Building Size			LMPA						Residence of Owner		Date of Purchase	
	<6 Units	6-11 Units	12+ Units	#1	#2	#3	#4	#5	#6	On Site	Off Site	Pre- 1978	Post- 1978
Salaries	0.065	0.084	0.185	0.162	0.141	0.114	0.142	0.124	0.028	.077	.140	.132	.134
Utilities	0.166	0.234	0.214	0.212	0.214	0.248	0.173	0.183	0.196	.202	.209	.233	.168
Electricity	0.046	0.076	0.102	.122	.066	.103	.058	.076	.056	.073	.086	.096	.065
Gas	0.012	0.075	0.101	.042	.106	.084	.076	.081	.049	.055	.080	.079	.072
Water & Sewer	0.108	0.082	0.011	.047	.042	.060	.038	.026	.091	.073	.043	.058	.031
Management	0.056	0.060	0.097	.061	.034	.075	.119	.084	.082	.054	.082	.059	.112
Parts & Supplies	0.108	0.063	0.071	.026	.127	.079	.076	.065	.054	.105	.073	.084	.066
Contract Maintenance	0.259	0.315	0.211	.291	.259	.247	.238	.237	.342	.243	.249	.257	.234
Taxes	0.243	0.163	0.150	.175	.129	.148	.189	.219	.232	.199	.171	.151	.212
Insurance	0.103	0.081	0.072	.074	.096	.089	.061	.088	.066	.120	.076	.085	.075

4.1.2 The Price Data

Exhibit 4-3 identifies the types and sources of data that can be used to track price changes for each of the major components of building expenses described above. All of this information is available from secondary data sources, and can be easily updated from year to year. Wherever possible, prices are measured on an October-to-September basis. However, in some instances, an alternative reporting period must be employed. A more detailed description of the data sources is presented in Appendix H.

One major area of concern is the treatment of property taxes. As part of this analysis, we examined information on the aggregate assessed values of multifamily residential properties in 1982, 1983, and 1984. Analyses of these data revealed an average annual tax increase of about 8 % (see Appendix H). However, Proposition 13 limits tax increases in buildings that do not turn over to 2% per year. As a result, using the 8% average to construct the cost-based Index would overcompensate the vast majority of City landlords who have not acquired their buildings during the Current period. Thus, the 2% maximum has been employed for purposes of this analysis.

Exhibit 4-4 presents information on price changes that have occurred since the enactment of rent stabilization. It shows that the prices of natural gas and water and sewer have increased most rapidly over the period, although the rate of inflation in the price of gas has dropped significantly in the last 12 months. Prices rose least rapidly for parts and supplies and building insurance. Two building inputs -- electricity and parts and supplies -- experienced a price decline in the most recent year, although the long-term rate of increase for electricity was relatively high. The Exhibit does not include price data for property taxes which, as we have seen in the previous chapter, actually declined over the period examined. However, in the analysis which follows, we shall assume a 2% property tax increase in future years.

EXHIBIT 4-3

EXPENDITURE CATEGORIES AND SOURCES OF PRICE DATA¹

<u>Expenditure Category</u>	<u>Source of Price Data</u>	<u>Period Covered</u>
Salaries	M&M Community Wage Rate Survey:	July - July
Utilities - Electric	cents per unit from DPW	June - May
Gas	cents per unit from Pacific Lighting	January - December
Water	cents per unit from DPW	June - May
Sewer	cents per unit from City	October - September
Management and Admin.	All-Item CPI for Los Angeles	October - September (12-month average)
Parts and Supplies	CPI (West) maintenance and repair commodities	October - September (12-month average)
Maintenance and Repair Services	CPI (West) maintenance and repair services	October - September (12-month average)
Taxes and Fees	2 percent per year	
Insurance	Dodge Building Cost Index	September - September (point estimates)

1. See Appendix H for a detailed discussion of these sources.

EXHIBIT 4-4

TRENDS IN THE PRICE OF BUILDING INPUTS: 1977-1984

	Annual Price Changes								Compounded	
Expenditure Category	1977	1978	1979	1980	1981	1982	1983	1984	% Change 1983-1984	Annual Rate 1977-1984
Salaries and Wages ¹	5.90	6.51	6.63	7.24	8.36	9.09	9.89	10.29	4.04	8.27
Utilities										
Electric ²	3.37	4.01	4.24	5.08	6.15	6.43	6.06	5.83	-3.80	8.15
Gas ³	187.48	195.35	257.06	340.51	357.16	451.93	580.16	606.61	4.56	18.26
Water and Sewer ²	.4159	.5074	.5063	.5349	.7894	.8806	.9851	1.1363	15.35	15.44
Management and Administration ⁴	100.00	106.90	116.96	135.44	149.69	161.73	164.10	171.00	4.20	7.97
Parts and Supplies ⁵	100.00	102.06	109.02	120.63	132.10	136.37	138.40	137.87	-0.38	4.70
Maintenance and Repair Services ⁵	100.00	103.28	112.92	125.07	138.67	151.60	155.87	166.12	6.58	7.52
Insurance ⁶	1045.5	1123.8	1170.9	1312.4	1457.2	1507.0	1506.1	1529.8	1.57	5.59

1. M&M Community Wage Rate Survey for Los Angeles County. Figures for 1977 to 1983 are weighted average rates reported for general maintenance workers, which do not account for changes in the group of firms reporting. The 1984 figure is calculated based on a 4.0% increase for this category of worker taken from the two-year constant participants information provided in the 1984 edition of the survey.
2. City of Los Angeles, Department of Water and Power. Average rates: cents per KWH for electric and dollars per 100 cu. ft. for water. Sewer charges are based on water usage and reflect a weighted average of residential and commercial rates.
3. Pacific Lighting Corporation, 1983 Annual Report. Average rate, cents per 1,000 cu. ft.; 1984 figure is preliminary.
4. All-Item CPI for Los Angeles.
5. CPI for all urban consumers. Annual averages (Oct. - Sept.) for Maintenance and Repair Commodities and Maintenance and Repair Services, western region.
6. Dodge Building Cost Index for U.S. and Canadian cities.

4.1.3 Constructing the Index

The price data presented in Exhibit 4-4 can be combined with the estimated expenditure weights to produce an Index which measures the overall increases in operating costs within a given period. Specifically, each price change can be multiplied by the weight which reflects that item's share in overall operating and maintenance costs. For example, if electricity represents 8% of the average building's operating and maintenance expenditures, changes in electrical rates will be weighted by 0.08. Summing the weighted price changes across the various items priced produces an "all-item" Index of operating costs that reflects the actual composition of expenditures for buildings in the Los Angeles market.

Exhibit 4-5 derives such an Index for the 1983-84 period. The first column presents the estimated expenditure weights for buildings in which the tenants pay utilities. The next column presents the price change that occurred between 1983 and 1984, while the third column presents the results when one multiplies the price changes by the expenditure weights. Summing these products over all the expenditure items produces an Index which measures the average annual cost increase that was experienced by Los Angeles landlords in these years. According to these estimates, this increase was about 3.7%, or a rate of increase somewhat below the rate of inflation as measured by the all-item CPI (4.2%).

The 3.7% estimated cost increase refers to the average building in the stabilized stock. In fact, however, as noted in a previous section, the relative importance of the different expenditure items varies by location and by building type. As a result, the overall cost increase will also vary. Exhibit 4-6 displays the breakdown by these variables. The first column presents the estimated 1983-84 cost increases by building size and LMPA. These figures were derived by assuming the same price inflation that was estimated Citywide, but allowing the underlying expenditure weights to differ. Thus, buildings that spend proportionately more on items that experienced the highest rate

EXHIBIT 4-5

CONSTRUCTING THE 1983-84 PIOC

	<u>Expenditure Weight</u>	<u>1983-84 Price Change (%)</u>	<u>Product</u>
Salaries	0.132	4.04	0.533
Utilities			
Electricity	0.084	-3.80	-0.319
Gas	0.077	4.56	0.351
Water & Sewer	0.048	15.35	0.737
Management & Administration *	0.079	4.20	0.332
Parts & Supplies	0.077	-0.38	-0.029
Contracted Maintenance	0.248	6.58	1.632
Taxes *	0.174	2.00	0.348
Insurance	<u>0.081</u>	<u>1.57</u>	<u>0.127</u>
Overall Price Increase			3.712% *

* As indicated in Appendix H, if we used IREM data for management and administrative costs and an 8% change in property taxes the result would have been 5.388%.

EXHIBIT 4-6

ESTIMATED COST INCREASE BY BUILDING TYPE AND LMPA

	1983-1984 Price <u>Increase</u>	Average Annual 1977-1984 <u>Increase</u>
All Los Angeles Properties	3.7%	8.0%
Master-Metered	3.7%	7.6%
Not Master-Metered	3.7%	7.6%
Number of Units		
1-5 Units	4.3%	6.8%
6-11 Units	4.4%	7.9%
12 or More Units	3.2%	7.8%
Owner Occupancy		
Owner Lives on Property	3.8%	7.2%
Owner Lives Away	3.7%	7.6%
Time of Purchase		
Before 1978	3.8%	7.8%
After 1978	3.6%	7.2%
LMPA		
1	3.7%	7.4%
2	3.7%	7.9%
3	3.7%	7.9%
4	3.8%	7.4%
5	3.4%	7.2%
6	4.7%	7.3%

of inflation should have the highest cost increase, while buildings that spend proportionately less should have the lowest overall increase.

Exhibit 4-6 also presents estimates of the "average" annual cost increase incurred between 1977 and 1984. These "long-term" estimates are designed to reflect price trends that are perhaps more typical of the entire rent stabilized period. They were derived by using current expenditure weights, which again differed by LMPA and building type. However, instead of 1983-84 price trends, we used the average annual price increase that occurred between 1977 and 1984 (the last column in Exhibit 4-4). Thus, the long-term price trends are designed to see if differences (or similarities) by LMPA or building type are unique to the current year, or have been fairly constant over the entire period of rent stabilization.

The most striking aspect of the Exhibit is the pattern of pronounced differences in cost increases when based on short-term, as against longer-term price trends. While costs increased by about 3.7% in the last year, the "average" rate of increase over the entire rent stabilized period was about twice as high (8%). This finding reflects the double-digit inflation that occurred in the early 1980s.

As is evident from the Exhibit, the estimated 1983-84 price increase was relatively constant by building type and location, despite observed differences in the expenditure weights. The only significant differences were found among different size properties, where the estimated cost increase ranged from about 4.3% in smaller buildings down to 3.2% in buildings with 12 or more units. The primary reason for these differences was the relatively large rate increase for water and sewer service (15%) that occurred between 1983 and 1984. Since such expenditures make up almost 11% of total costs in smaller buildings -- compared to only about 1% of costs in larger ones -- this rate increase had a large impact on overall trends when arrayed by

building type. Note that, if calculated on the basis of long-term price trends, smaller buildings typically experienced a lower rate of increase.

4.1.4 Deriving a Ratio to Relate Costs to Rents

The last step in the derivation of a cost-based rent adjustment formula is to calculate a ratio that can be used to relate changes in costs to allowable changes in rent.² The issue of the "appropriate" ratio to apply is inherently subjective, and reflects a judgment on the extent to which net operating income (defined as the difference between gross rental income and total operating and maintenance costs) should be allowed to increase over time.

Following consultation with the City's Rent Stabilization Division, we have employed an approach that will maintain the "real" value of the building's cash flow (defined as net operating income minus mortgage payments).³ This type of formula would indemnify owners against annual changes in operating costs, while at the same time protecting their profit margins (absent subsequent changes in the financing of the property).

As noted in an earlier section, the overall operating cost-to-income ratio was 43% in the landlord survey. However, for buildings in which the tenants pay utilities --which is the basic sample which has been used to derive the cost-based index -- the ratio was 41%. The ratio of pre-tax cash flow to building income was 17% for the survey sample as a whole as well as for the subset of buildings in which the tenants pay utilities. Finally, the increase in the all-item CPI was 4.2% between 1983 and 1984 (based on a 12-month average of the index value, beginning in October and ending in September). Thus, using the parameters derived from landlord survey, the formula given above would yield an allowable rent increase of 2.23% for that year.⁴

4.1.5 Alternative Estimates of the Index Parameters

The above standard was based on data derived from the landlord survey. Since the sample was relatively small, the estimated cost parameters could prove to be biased or unreliable. Accordingly, it is important to compare the Index derived from the landlord survey with comparable statistics obtained from other sources.

This is accomplished in Exhibit 4-7, which presents expenditure weights and expense-to-income ratios that have been derived from the IREM and the FTB data. Unfortunately, neither data set allows the same level of disaggregation of costs that was possible with the landlord survey. However, it is possible to construct expenditure weights based on four main components of operating costs: utilities, taxes and fees, insurance, and all other expenses combined.⁵ Note that the FTB data have again been weighted to reflect the underlying distribution of properties by LMPA and building size.

The Exhibit shows that the FTB and landlord survey data yield roughly comparable expenditure weights. While the weights associated with utilities, taxes, and insurance are all somewhat lower in the FTB sample, the differences are relatively small. The expenditure weights derived from the landlord survey can be used to derive composite price increases for the items included under "utilities" and "other expenditures."⁶ Using these composite price increases, along with the FTB expenditure weights, produces an overall operating cost increase of 3.8%. This estimate is virtually identical to the one derived from the landlord survey (3.7%).

The operating expense-to-income ratios are also about the same when based on either the landlord or the FTB data. However, the ratios of cash flow to building income are considerably different, depending on the data base employed. As noted in the previous Chapter, financing costs in the landlord survey include both interest and principal payments, while the FTB data include expenditures on interest alone. Naturally, the ratio of financing costs-to-building income is thus higher in the landlord sur-

EXHIBIT 4-7

COMPARISON OF EXPENDITURE WEIGHTS

	<u>IREM²</u>	<u>FTB</u>	<u>Landlord Survey¹</u>	
			<u>All Buildings</u>	<u>Large Buildings</u>
Utilities	0.212	0.181	0.209	0.214
Taxes	0.128	0.163	0.174	0.150
Insurance	0.043	0.070	0.081	0.072
Other Expenses	0.617	0.586	0.536	0.564
Operating Costs- to-Income Ratio	0.38	0.42	0.41	.45
Cash Flow-to-Income Ratio	N/A	0.24	0.17	.15

-
1. Weights are for buildings in which the tenants pay utilities.
 2. The IREM data reports median square foot costs by a number of building components. Not all buildings report costs in every category, particularly in the case of utilities. As a result, aggregate expenditures on a given item in a given building type had to be estimated by multiplying the reported square foot costs by the product of two variables: (1) the total amount of square feet in the sample for the building type; and (2) the proportion of buildings reporting the particular expenditure item.

vey, making the cash-flow-to-income ratio relatively low. Again, the decision as to the appropriate ratio to use is inherently subjective, depending upon whether or not one wishes to allow "payments to equity" to increase with inflation.

Differences between the expenditure weights that are derived from the IREM data and those based on the landlord survey are more pronounced. While the weights associated with utilities are virtually the same, the weights associated with taxes and insurance are considerably lower in the IREM sample. Nevertheless, the composite price increases for utility and other expenses, along with the estimated IREM weights, yield an overall price increase of 3.9%. Again, this is about the same as overall operating cost index derived from the landlord survey (3.7%). The expense-to-income ratio is also consistently lower in the IREM data. However, as discussed in a previous section, this difference may reflect the fact that the IREM data cover the entire metropolitan area.

On the whole, the consistency in the estimated parameters that have been derived from the various data sets is reassuring, and should make one reasonably confident that the cost-based Index described herein would do a relatively good job of tracking trends in building costs. The only major discrepancy between an index based on the landlord survey and one using the FTB data is in the cash-flow-to-income ratios, which relates more to the definition of "building cash flow" than to the nature of the underlying samples. In the analysis which follows, we have used the 17% ratio that was derived from the landlord survey. This ratio holds the equity payment constant over time, but allows remaining cash flow to increase with inflation. The formula could be easily modified should an alternative approach be deemed more appropriate.

4.2 Comparing the Impacts of Alternative Rent Adjustment Formulas

This section compares several options to the current rent adjustment ceiling, and estimates the relative impacts of the different formulas on tenants, landlords, and government tax revenues. We begin by defining the optional formulas and examining the annual percentage rent increases that each would have allowed in the period from 1977 to 1984. Next, we estimate the impact of alternative formulas on Los Angeles tenants, focusing on changes in rents and rent-to-income ratios, and grouping households by income, race, age, size, length of tenure, building size, and location (LMPA). The analysis then turns to the impacts of alternative formulas on landlords, estimating changes in net operating incomes by date of purchase, owner residence, building size, and location (LMPA). Finally, we estimate the net effects of alternative formulas on tax revenues.

Throughout this section, the analysis deals with the relative impacts of different formulas. We have not been requested to simulate comparable outcomes in an unregulated housing market. In addition, our estimates of rents, incomes, and operating costs all represent projections only one year into the future. While we employ both current and historical price trends in making these projections, we are not forecasting the long-term, cumulative effects of alternative rent control formulas. Finally, all of the rent adjustment formulas considered in this section retain the existing system of vacancy decontrol. Alternatives to vacancy decontrol are addressed in a subsequent section.

4.2.1 Alternative Rent Adjustment Formulas

Six different rent adjustment formulas have been considered in this analysis. The formulas are described below:

- * Seven Percent. The first formula would continue the current system, and allow rents in buildings where tenants pay their own utilities to increase by 7% a year.

- * CPI. The second formula would allow rents to increase annually by the percentage change in the All-Item Consumer Price Index for the Los Angeles Standard Metropolitan Statistical Area (SMSA), averaged over the October to September period.
- * Non-Shelter CPI. The third formula would allow rents to increase by the percentage change in the non-shelter component of the Los Angeles CPI. (This formula attempts to avoid any feedback from one year's rent adjustment allowance to the subsequent year's CPI.)
- * Percent of CPI. The fourth formula would allow rents to increase by a fixed fraction of the change in the All-Item CPI, where the fraction represents the average ratio of operating costs and cash-flow to building income. (This formula attempts to compensate landlords for changes in operating costs and for the effects of inflation on the real value of cash-flow, while recognizing that financing costs typically do not change. The landlord survey yields an operating cost-to-income ratio of 41% and a cash flow-to-income ratio of 17%. Therefore, this formula would allow rents to rise by 58% of the CPI.)
- * Cost-Based Index. The fifth formula would relate rent increases to actual changes in operating costs, and protect landlords' cash-flow from inflation. However, it would not compensate landlords for fixed financing expenses. (This formula was discussed at length in the previous section, and represents a weighted average of the CPI and the estimated PIOC.)
- * Fair Rate of Return. The sixth formula would allow rents to increase enough to yield a "fair" rate of return to investors. In particular, it assumes that the pre-tax return on value should be equal to the weighted average of the current mortgage interest rate and the interest rate on low-grade (Baa) municipal bonds. The weights are designed to reflect the typical share of debt and equity for a newly financed property, which are assumed to be 80% and 20%, respectively. (The underlying premise behind this formula is that expected returns to investors should be sufficient to attract new capital from other uses, as well as to maintain existing investments.)

The sixth, or Rate of Return formula behaves very differently from all of the others and is therefor treated in the following section.

Exhibit 4-8 presents the percentage increase in rents that the first five formulas, if put in place starting in 1977-78, would have allowed in each year from 1977 through 1984. Note

EXHIBIT 4-8

ANNUAL PERCENTAGE RENT ADJUSTMENTS UNDER
ALTERNATIVE FORMULAS

	<u>Fixed Adjustment</u>	<u>Full Inflation Adjustment</u>		<u>Partial Inflation Adjustment</u>	
	<u>7%</u>	<u>All- Item CPI</u>	<u>Non-Shelter CPI</u>	<u>% CPI</u>	<u>Cost- Based</u>
1977-78	7.00%	6.90%	6.18%	4.00%	3.96%
1978-79	7.00%	9.41%	8.90%	5.46%	4.63%
1979-80	7.00%	15.80%	12.41%	9.17%	7.48%
1980-81	7.00%	10.52%	9.51%	6.10%	6.71%
1981-82	7.00%	8.04%	7.37%	4.67%	4.65%
1982-83	7.00%	1.47%	3.55%	0.85%	2.18%
1983-84	7.00%	4.20%	3.61%	2.44%	2.23%
Ave. Annual Increase	7.00	7.97	7.32	4.64	4.48

that in making these calculations the expenditure weights, the operating expense-to-income ratio, and the cash-flow-to-income-ratio have all been held constant. Only the CPI and price terms have been assumed to vary from year to year. While expenditure weights and expense-to-income ratios can (and do) vary over time, there was no way to reconstruct their historical values. Nevertheless, the data should provide reasonable estimates of the relative movements of the different indices.⁷

The first major finding that emerges from the Exhibit is that the various adjustment formulas tend to move together, and are, in fact, highly correlated. By definition, the percentage CPI formula yields adjustments that are always exactly 58% of those allowed under the full CPI formula. In addition, the correlation of these two formulas with the Non-Shelter CPI formula is 98%, while their correlation with the Cost-Based Index formula is 95%. The correlation between the Non-Shelter CPI formula and the Cost-Based Index formula is 97%.

The fact that the indices are highly correlated reflects the fact that building costs have tended to move with the overall inflation rate. However, a high correlation between the various indices does not imply that they would produce the same allowable rent increase. In the broadest terms, the various indices can be divided into two distinct groups: those which move with general economic trends and those that are fixed over time. Only the current adjustment formula (the 7% ceiling) falls into the latter category.

Among the inflation-sensitive indices, those based on the CPI and the non-shelter component of the CPI represent a "full inflation" pass-through. The cost-based index and the "percent of CPI" formula, on the other hand, contemplate that mortgage interest and principal payments are relatively constant over time, and compensate landlords through rent increases for only the variable components of building costs. The resulting rent increases are thus about 40% lower than the ones derived from either the all-item or non-shelter component of the CPI.



As to the workings of the existing formula, the Exhibit shows that in the first year of rent stabilization (1978), the 7% standard matched the CPI. However, in the next four years, the increase in the CPI exceeded 7%, with the differences most pronounced in 1980 and 1981. Then, inflation abated, and the 7% standard has been significantly above the CPI (as well as the other indices) in recent years. For the most part, the CPI and the non-shelter CPI indices yield roughly comparable rent increases every year. However, the increase in the CPI has typically been about 0.5% higher than the increase in the non-shelter CPI, suggesting that housing cost inflation has typically exceeded inflation in other components of the basket of goods and services that is used to track general price inflation.

It will be noted that the rent increases yielded by the "percent of CPI" and cost-based indices are remarkably similar, and well below the increases suggested by other formulas. The fact that the indices move together suggests that variations in building operating and maintenance costs have typically tracked variations in the overall rate of inflation. The reason that the two indices produce allowable rent increases that are significantly below the other formulas is that, in effect, both formulas set the standard at about 58% of inflation, rather than at the full inflation rate.

The cumulative effect of these different formulas over the 1977 to 1984 period is illustrated in Exhibit 4-9, which tracks the history of a hypothetical rental unit, assuming no turnover, an initial rent of \$100 and a maximum allowable increase in rent each year under each formula. Under these assumptions, the 1984 rents achieved under the current 7% ceiling are almost identical to those that would have been produced if the non-shelter CPI had been used as a ceiling, and marginally below those that would have been produced with the all-item CPI. Thus, although allowable increases in a given year would have been quite different, the net effect to date would have been much the same. In contrast, if either the "percent-of-CPI" or the "cost-based index" had been implemented, the rents paid by tenants who did not move

EXHIBIT 4-9

CUMULATIVE RENT ADJUSTMENTS UNDER ALTERNATIVE FORMULAS

	<u>Fixed Adjustment</u>	<u>Full Inflation Adjustment</u>		<u>Partial Inflation Adjustment</u>	
	<u>7%</u>	<u>All- Item CPI</u>	<u>Non-Shelter CPI</u>	<u>% CPI</u>	<u>Cost- Based</u>
1977	\$100	\$100	\$100	\$100	\$100
1978	\$107	\$107	\$106	\$104	\$104
1979	\$114	\$117	\$116	\$110	\$109
1980	\$123	\$135	\$130	\$120	\$117
1981	\$131	\$150	\$142	\$127	\$125
1982	\$140	\$162	\$153	\$133	\$131
1983	\$140	\$164	\$153	\$134	\$133
1984	\$161	\$171	\$164	\$137	\$136

during the period would have been about 16% below both their current levels and the levels that would have resulted from either the all-item or the non-shelter CPI.

4.2.2 The Rate of Return Formula

The Rate of Return formula requires special consideration for several reasons. First, any attempt to link allowable rent increases to a "fair" rate of return raises the fundamental question of what level of return might be considered "fair." In conjunction with the City and its project Steering Committee, we considered several alternative definitions of a "fair" rate of return before implementing this analysis. One option was to adopt an average historical rate (possibly from the pre-rent stabilization period) as the "fair" rate to be maintained in the future. The primary drawback of this approach is that market conditions fluctuate over time, with returns on competing investment opportunities rising and falling. A fixed "fair" rate of return would be too low to attract new investment during some years and would be excessively high relative to competitive opportunities in other years.

Thus, to maintain a flow of investment into real estate, it seemed reasonable to define a "fair" rate of return that varied with the shifting rates of return offered by competing opportunities. Moreover, since real estate involves both debt and equity investment, it was agreed that total return on value to real estate should be viewed as a weighted average of return on debt (i.e., the mortgage interest rate) and return on equity. The last outstanding problem was to identify a published interest rate that corresponded, both in terms of risk and in terms of tax benefits, to equity investment in real estate. Low-grade municipal bonds (Baa) were selected because they are somewhat risky and yield tax-free income. An alternative was the interest rate on second mortgages, which do not enjoy the full security interest of first mortgages.

In implementing any fair rate of return formula, the calculation of each year's allowable percentage rent increase depends upon the rate of change in operating costs and the rate of appreciation of property value. Specifically, such a formula requires that one find the rent increase that makes the pre-tax return on value equal to a weighted average of the mortgage rate and the yield chosen as a standard, in this case the current return on low-grade municipal bonds.⁸ However, under the real estate market conditions that now exist and have long existed in Los Angeles, any calculation of the rent adjustment implied by any standard that has been suggested for the "fair" rate of return formula, whether one uses historical or current price and interest rate trends, usually results in a substantial annual reduction in allowable rents.

This result follows from the fact that no standard measure of competitive investment yield has grown more rapidly in most recent years than Los Angeles rental properties have appreciated in value. Neither have many Los Angeles stabilized properties been unprofitable. The combination of appreciation and profit regularly exceeds all competing rates of return suggested.

In the most recent year, for example, the landlord survey indicates that the average returns on the 1983 value of rent stabilized properties (including appreciation gains) amounted to about 17%, considerably higher than the 12% weighted average of mortgage interest and municipal bond rates. This relatively high rate of return was primarily due to the appreciation in property values. While the ratio of NOI to current value was only about 5.6%, property values appreciated by 11.4%.

Moreover, 1983 does not appear to have been an idiosyncratic year. Exhibit 4-10 compares average annual returns on rental property value from the DAMAR property sales data, set against the "fair" rates of return for every year from 1977 to 1983. Except in 1980, when average return dropped close to zero, average returns substantially exceeded the "fair" market rate.⁹ Exhibit 4-10 also provides the information necessary to compare historic returns to alternative definitions of a "fair" rate

EXHIBIT 4-10

AVERAGE ANNUAL RETURNS ON VALUE FOR
DAMAR PROPERTIES: 1977-1984

	<u>DAMAR Average Rate</u>	<u>"Fair" Rate</u>	<u>Mortgage Rate</u>	<u>Bond Rate</u>	<u>Weighted Average of Mortgage Rate and Second Mortgage Rate</u>
1977-78	19.1%	8.87%	9.56	6.11	9.96
1978-79	21.6	9.92	10.78	6.49	11.18
1979-80	13.0	11.81	12.66	8.39	13.06
1980-81	0.3	13.95	14.70	10.96	15.10
1981-82	16.2	14.73	15.14	13.07	15.54
1982-83	17.4	12.12	12.57	10.33	12.97
1983-84	13.7	11.96	12.38	10.28	12.78

-- the mortgage interest rate itself, the bond rate and the weighted average of the mortgage interest rate and a typical rate on second mortgages (assumed to be two points above the mortgage rate). In most years during the 1977-1984 period average returns appear to have exceeded these standards as well. Even if we used current debt-to-equity ratios (70% to 30%, rather than the 80% to 20% typical of newly acquired properties), use of the second mortgage definition of "fair" would still yield a rent reduction for Los Angeles properties in 1985.

Such findings vividly illustrate two major difficulties with a rate-of-return formula. First, it is extremely hard to identify a readily available rate that can be agreed upon as a reasonable standard for a "fair" return on equity investment in real estate. Second, while landlords may indeed benefit from appreciation of their properties, realization of most appreciation gains (e.g., other than increases in collateral for borrowing) only occurs at the time that the property is sold. No generally accepted technique exists for discounting the value of appreciation over time, and ignoring it until the year of sale would, if applied in a formula, yield ludicrous results in the year when the capital gain was realized. Yet, keeping pace with appreciation would mean that a property could easily generate a relatively high rate of return at the same time its owner was faced with a very small or even a negative cash-flow. Since rent reductions of the magnitude suggested by any rate-of-return formula tested would clearly produce a severe strain on building finances, we have not included this sort of formula as an option in the impact analysis presented below.

4.2.3 Impacts on Tenants

How would the five formulas described above affect the rents actually paid by Los Angeles tenants? We have seen that the various formulas can be classified according to their sensitivity to inflation and, among the inflation-sensitive indices, the extent to which they preserve the "real" (i.e., inflation-adjusted) value of net operating income. Choices among these



broad parameters would lead to significantly different allowable rent increases and could thus have a major impact on the level of benefits received by the City's tenants. Ideally, one would like to know exactly what conditions would be like today had one or another of the various formulas been enacted in 1977. One would also like to be able to forecast the outcome in future years. Unfortunately, given the immense number and complexity of the factors that affect inflation, interest rates, the relative attractiveness of housing and other key factors, man's ability to predict the future -- or even to reconstruct the past -- is limited. As a result, this component of the analysis is necessarily modest in scope.

Over the entire stabilization period (i.e., 1977 to 1984) the 7% ceiling yielded about the same overall rent increase for tenants who did not move as did the all-item CPI and non-shelter CPI indices. Thus, it seems reasonably safe to assume that average monthly maximum allowable rents would be pretty much the same today had either of these two options been adopted. However, we also found that the 7% ceiling -- which is, of course, insensitive to economic trends -- now allows significantly higher percentage increases in rent than any of the other five formulas, including these two. Thus, it seems likely that, unless inflation begins to rise -- which is possible but not inevitable -- continuation of the current ceiling would have a significantly different effect on the City's tenants in the future than would either the all-item CPI or the non-shelter CPI formula. In the short term, assuming no inflationary rise, either formula would permit substantially smaller rent increases than the 7% ceiling permits.

It also appears that, had the "cost-based" or "percent-of-CPI" formula been adopted in 1977, things would be very different today. Rents for long-term tenants would undoubtedly be lower than they are, since both formulas limit the amount of inflation that can be passed through to building residents. However, the impact on recent movers (and on landlords) is more problematic.

The analysis of tenant benefits (Chapter 2) documented the mark-ups above the previous tenant's rent paid by households who moved into their units during the last three years. It is likely that any formula that produced a lower allowable rent increase for in-place tenants would also have increased the average markup paid by these households. However, the magnitude of the increase, as well as the impact on aggregate benefits, is difficult to determine because of the maelstrom of other economic fluctuations that were occurring in many of the years since 1978.

One's ability to project into the future is also limited, given highly imperfect ability to forecast the future course of prices with high confidence, as well as the reactions of the market place to those price developments. However, one can make some short-term projections regarding rents and rent-to-income ratios in 1985 if one of the formulas were enacted and implemented today. In making these projections, we have employed two sets of data. The first consists of price trends observed in 1984 (and reflect the allowable rent increases for 1985 if each of the formulas were adopted today). The second consists of the average annual price increase observed over the entire period 1977-84. The latter estimates are simply intended to show how the different formulas would operate under "normal" conditions in the event that last year's trends turn out later to have been unusual or idiosyncratic. These projections are not meant to simulate the long-term impact on the City's tenants if a system using any of the formulas were adopted.

Estimating next year's rents and rent-to-income ratios was done in a four-step process, involving a number of simplifying assumptions. First, we calculated the 1985 rent for in-place households (i.e., non-movers), assuming that the maximum rent increase was charged. Second, we estimated the 1985 rents for households that moved, assuming that the markups observed in 1984 would be maintained in the upcoming year. Third, we combined the projected rents of movers and stayers, assuming that the proportion of households who moved in 1985 would be the same as in 1984.¹⁰ And, finally, in order to estimate gross rent-to-income

ratios in the upcoming year, we inflated utility costs by the increase observed between 1983 and 1984 (3.7%) or, for analysis based on 1977-84 price trends, by the average annual increase over that period (13.6%). We simulated 1985 tenant incomes by inflating the 1984 levels by the 1984 all-item CPI for 1984.¹¹

This methodology also employs a number of simplifying assumptions. To begin with, it assumes that households that move pay the same proportionate rent markup for their new apartments, regardless of the formula in effect. In other words, since recent movers paid 14% more rent on average than did other households in 1984, we assumed that landlords would continue to charge the same proportionate markup in 1985, regardless of which rent adjustment formula is put into effect. In fact, however, a lower ceiling on rent increases for units that do not turn over might result in higher proportionate markups, as landlords attempted to maintain their overall revenues. Correspondingly, a 14% markup over higher ceilinged rents may overestimate what would be charged to movers. If markups actually vary inversely with rent adjustments, our estimates will overstate the differences between rents paid by moving and non-moving tenants under different formulas.

Assuming that recent movers always pay 14% more than stayers also implies that landlords would increase a unit's old rent by differing amounts upon turnover, depending on the adjustment formula that is in effect. Specifically, under the current 7% ceiling, a unit with a new occupant in 1985 would rent for about 21% more than it did in 1984 (i.e., the 7% rent increase that would have been charged the old tenant, plus a 14% markup). At the opposite extreme, under the cost-based formula, a unit with a new occupant in 1985 would rent for only about 17% more than it did in 1984 (the lower allowable increase to the old tenant, plus the markup). Again, if one believes that landlords would vary the markup or the rent increase in light of their perceptions of market conditions or for other reasons, so that the actual rental

charged would not be different under differing formulas, then our estimates would overstate the differences in the effects of alternative formulas.

Finally, our methodology also assumes that household mobility rates will not be sensitive to adjustment formulas, and that they will be the same in the upcoming year as they were in 1984. It seems likely that a relatively low allowable rent increase would tend to reduce mobility rates over time, both by increasing the savings to long-tenured tenants and, perhaps, by increasing the markups charged to recent movers. However, since we are only forecasting rents in the upcoming year -- and any impact would be conjectural in view of the evidence in Chapter 2 that mobility rates have not yet been significantly affected by the current stabilization program -- we have assumed a constant mobility rate. Note that all of these assumptions tend toward overstatement rather than understatement of the difference between various formulas. If there is error in the projection, therefore, one would expect it to be toward that side of the ledger.

Exhibit 4-11 presents the projected effects of each of the five formulas on all Los Angeles rent-stabilized households.¹² The estimates shown as based on "current prices" use the adjustment factors that result from CPI and price changes observed during the year 1984, while the estimates based on "average" prices reflect the average annual price increase that occurred over the entire period, 1977-84.

The Exhibit shows that, based on current prices, the present 7% ceiling yields the highest 1985 average gross rent (\$486 per month) and rent-to-income ratio (29.8%). The other formulas produce average gross rents between \$467 and \$475 per month, and generate lower rent-to-income ratios (28.5% to 29.1%). This basically reflects the fact that all measures of consumer price and building cost inflation rose by less than 7% during 1984. However, when the projections are based on the average change in prices that has occurred during the last six years, the CPI and Non-Shelter CPI formulas produce substantially higher rents than does the 7% ceiling, while the Percent of CPI and Cost Based

EXHIBIT 4-11

IMPACTS OF ALTERNATIVE ADJUSTMENT FORMULAS
ON LOS ANGELES TENANTS

	<u>Contract Rent</u>	<u>% Change Contract Rent</u>	<u>Gross Rents</u>	<u>Gross Rent as % of Income</u>
1984 Averages	\$401		\$446	28.5%
<u>1985 Estimates Based on Current Prices</u>				
7%	\$441	9.98	\$486	29.8%
CPI	\$430	7.23	\$475	29.1%
Non-Shelter CPI	\$427	6.48	\$472	28.9%
%CPI	\$423	5.49	\$468	28.7%
Cost-Based	\$422	5.24	\$467	28.5%
<u>1985 Estimates Based on Average Trends</u>				
7%	\$441	9.98	\$490	29.0%
CPI	\$445	10.97	\$494	29.2%
Non-Shelter CPI	\$443	10.47	\$492	29.1%
%CPI	\$432	7.73	\$481	28.5%
Cost-Based	\$431	7.48	\$480	28.4%

Index formulas continue to yield lower rents than would the current flat cap. It is also interesting to note that the Percent of CPI formula yields virtually the same rents as the Cost-Based Index formula under the two alternative price assumptions. Similarly, the CPI and Non-Shelter CPI formulas serve as close substitutes for one another. The 7% ceiling on the other hand, though insensitive to changes in inflation rates, comes close to matching the CPI and Non-Shelter CPI formulas when based on six-year trends, while far exceeding them under 1983-1984 price conditions.

But would the competitive rental housing market in the Los Angeles area -- which includes many unstabilized units outside the City -- permit the maximum allowable increases to be charged under all formulas? The analysis of tenant benefits found that recent movers pay rents that are higher than those that would prevail in the absence of stabilization. However, there is no strong evidence that average stabilized rents, looking across all tenure subgroups, ever exceed the average rents that would be paid in an unstabilized market. If any of the formulas reported in Exhibit 4-11 would yield average maximum allowable rents higher than unregulated levels, then the rent increases actually charged by landlords would probably be constrained below the maximum by market conditions. Looking first at the formula estimates based on historical price trends, we know that our two concepts of rent levels in Los Angeles if stabilization had never been enacted: Imputed Rents and Market Rents, rose by between 11% and 11.5% annually over the 1977-1984 period. None of the formulas yield annual average increases of more than 11%, so it seems unlikely that market conditions would act as a constraint against charging the maximum increase permitted by each. Turning to the projection based on 1984 prices alone, we do not know how much Market or Imputed Rents will increase in the upcoming year. If rents typically increase faster than the CPI in Los Angeles's tight housing market, as they did over the full 1977-1984 period, we can assume that the average ratio between change in rent and

change in the CPI for the period (11.5/7.97) is a typical relationship. If so, average Market Rents (i.e., the rents charged to new tenants for vacant stabilized units) can be estimated as increasing by about 6.03% between 1983 and 1984. Assuming that the workings of the market would not permit average regulated rents to rise above this rate of increase, average contract rents in 1985 would be constrained to about \$436 per month. The only one of the formulas that would be affected by this constraint would be the current 7% ceiling, which would give landlords about 1.1% more leeway to raise or markup rents than the market would probably permit them actually to use.

Exhibit 4-12 presents gross rent and gross rent-to-income ratio estimates, based on 1984 price experience, for household groups classified by income, race/ethnicity, age, household size, length of tenure, building size, and LMPA location. For all of these households, the adjustments allowed under each formula remain the same; what differs is the share of movers and the average rent markup paid by recent movers. In addition, all groups are assumed to experience the same rate of income growth. For groups with high rates of mobility and large markups, rent increases will be higher, while groups with low mobility rates will experience lower average rent increases. Nevertheless, the relative attractiveness of the optional formulas from the perspective of the tenants remains unchanged, assuming that the formula that yields the smallest percent increase will be preferred by all groups of tenants, even those with high mobility rates.

To show why even highly mobile tenants may rank the attractiveness of alternative formulas in the same order as less mobile households, let's examine a specific example. Using 1983-1984 prices as a basis for projection, the lowest ceiling on 1985 rent adjustments (2.23%) is produced by the Cost-Based Index formula, and the highest rent adjustment factor is produced by the 7% cap. Let us compare the impacts of these two formulas for a high-mobility group (households headed by persons under age 30) and a low-mobility group (households aged 62 or over). Among young

EXHIBIT 4-12

IMPACTS OF ALTERNATIVE FORMULAS ON LOS ANGELES RENTERS, BY HOUSEHOLD GROUP

	1984		% Change in Gross Rent 1985 (Current Price)					1985 Gross Rent-to-Income Ratios				
	Gross Rent	Gross Rent-to-Income Ratio	7%	CPI	Non-Shltr CPI	% CPI	Cost-Based	7%	CPI	Non-Shltr CPI	% CPI	Cost-Based
Income												
< \$10,000	\$272	51.9%	9.56%	6.99%	6.25%	4.78%	4.78%	54.57%	53.29%	52.92%	52.19%	52.19%
\$10-20,000	\$405	37.0%	9.63%	6.91%	6.42%	5.43%	5.19%	38.93%	37.96%	37.79%	37.44%	37.35%
\$20-30,000	\$448	24.5%	8.71%	6.03%	5.58%	4.46%	4.24%	25.56%	24.93%	24.82%	24.56%	24.51%
\$30-40,000	\$507	18.8%	8.68%	6.11%	5.52%	4.54%	4.34%	19.61%	19.14%	19.04%	18.86%	18.83%
\$40,000 +	\$563	15.3%	11.01%	8.35%	7.82%	6.75%	6.57%	16.30%	15.91%	15.83%	15.67%	15.65%
Race/Ethnicity												
White	\$486	27.9%	10.49%	7.82%	7.20%	6.17%	5.97%	29.58%	28.87%	28.70%	28.43%	28.37%
Black	\$402	30.2%	9.95%	7.46%	6.72%	5.72%	5.72%	31.87%	31.14%	30.93%	30.64%	30.64%
Hispanic	\$371	29.1%	8.09%	5.66%	5.12%	4.04%	3.77%	30.19%	29.51%	29.36%	29.06%	29.98%
Other	\$453	27.2%	10.06%	7.95%	7.51%	6.40%	6.18%	28.87%	28.18%	28.06%	27.77%	27.72%
Age of Head												
< 30	\$460	30.1%	10.87%	8.26%	7.61%	6.52%	6.30%	32.03%	31.27%	31.09%	30.77%	30.71%
30-61	\$447	26.7%	9.40%	6.94%	6.26%	5.15%	4.92%	28.03%	27.40%	27.23%	26.94%	26.88%
62 +	\$379	33.4%	7.65%	5.01%	4.49%	3.43%	3.17%	34.51%	33.66%	33.49%	33.15%	33.07%
Household Size												
One	\$384	28.4%	10.68%	7.81%	7.29%	6.25%	5.99%	30.17%	29.38%	29.24%	28.96%	28.89%
Two	\$485	27.2%	8.04%	5.57%	4.95%	3.92%	3.71%	28.20%	27.56%	27.40%	27.13%	27.07%
3-4	\$485	29.0%	10.52%	8.04%	7.42%	6.39%	6.19%	30.76%	30.07%	29.90%	29.61%	29.55%
5 +	\$434	32.1%	10.37%	7.83%	7.37%	6.22%	10.37%	34.00%	33.22%	33.08%	32.72%	34.00%
Length of Tenure												
< 1 Year	\$496	28.7%	20.56%	17.54%	16.94%	15.73%	15.52%	33.21%	32.37%	32.21%	31.88%	31.82%
1-2	\$495	30.6%	6.87%	4.24%	3.64%	2.63%	2.42%	31.38%	30.61%	30.44%	30.14%	30.08%
3-5	\$440	27.2%	6.82%	4.32%	3.64%	2.73%	2.50%	27.88%	27.23%	27.05%	26.82%	26.76%
6 +	\$371	26.7%	6.74%	4.31%	3.77%	2.70%	2.43%	27.35%	26.73%	26.59%	26.32%	26.25%
Building Size												
< 5 Units	\$427	28.3%	8.90%	6.56%	5.85%	4.92%	4.68%	29.58%	28.94%	28.75%	28.50%	28.43%
6-11	\$430	28.9%	11.63%	8.84%	8.37%	7.21%	6.98%	30.96%	30.19%	30.06%	29.73%	29.67%
12 +	\$466	28.6%	9.23%	1.93%	6.01%	4.94%	4.72%	29.98%	27.98%	29.10%	28.80%	28.74%
LMPA												
1	\$362	26.3%	9.39%	6.63%	6.08%	5.25%	4.97%	27.61%	26.91%	26.77%	26.57%	26.50%
2	\$378	29.7%	11.64%	8.99%	8.47%	7.41%	7.41%	31.82%	31.07%	30.92%	30.61%	30.61%
3	\$436	28.2%	10.09%	7.34%	6.88%	5.73%	5.50%	29.79%	29.05%	28.93%	28.61%	28.55%
4	\$497	28.3%	9.46%	6.84%	6.24%	5.23%	5.03%	29.73%	29.02%	28.85%	28.58%	28.53%
5	\$584	29.6%	7.71%	5.14%	4.62%	3.42%	3.25%	30.60%	29.87%	29.72%	29.38%	29.33%
6	\$421	29.2%	11.16%	8.55%	8.08%	6.89%	6.89%	31.15%	30.42%	30.29%	29.95%	29.95%

households, the mobility rate is 39% per year and recent movers pay an average mark-up of about 11%. For these households, the Cost-Based Index formula would allow average rents to rise by 6.5% in 1985, while the current ceiling would permit average rents to rise by 11.5%.¹³ Thus, the ceiling now in place would allow increases in the rents paid by this highly mobile group that would average 4.7% more than the Cost-Based Index would permit. By comparison, the mobility rate among elderly households is only 6.2% per year, with an average markup to recent movers of 26%. For these households, the Cost-Based Index formula would limit the average 1985 rent increase to 3.2%, while the current 7% ceiling on the rents of non-moving tenants would allow their average rents to increase by 8.2% in 1985. For this largely immobile group as well, therefore, the current flat ceiling would also permit significantly larger (4.8%) increases than would the cost-based formula.

Thus, while mobility rates are an important factor in determining the average rents paid by particular subgroups of tenants, the relative financial attractiveness of these alternative formulas would not be expected to vary across differing segments of the tenant population. Over time, different formulas might result in different rates of mobility or in different mark-ups for recent movers, but these second-order effects have not been considered here.

We now turn to estimating the financial effects on Los Angeles tenants if rent stabilization took the form of one of these formulas as against what their rents would be if no form of stabilization had ever been enacted. It will be recalled that in Chapter 2, we estimated that the average 1984 rent savings from the current stabilization system, taking all tenants as a whole, range between \$7 and \$18 per month, depending upon one's assumptions about rent levels in the absence of stabilization. Exhibit 4-13 presents several estimates of average 1985 financial effects under the optional adjustment formulas. A net average saving appears as a positive figure in the Exhibit; a minus sign indicates a net cost to tenants.

In order to calculate these estimates, it was necessary to inflate the 1984 Imputed Rent and Market Rent estimates to 1985 terms. We have produced two sets of forecasts, one of which uses the average annual change in Imputed Rents over the 1977-1984 period (which was 11.5%), and the other of which assumes that the relationship of Imputed Rents to CPI growth (11.5% to 7.97%) persists into 1985, yielding the 6.03% annual rate of increase in unstabilized rents mentioned earlier.¹⁴

The figures in Exhibit 4-13 suggest that either the CPI or Non-Shelter CPI formula would maintain the net average financial benefit of stabilization to all tenants as a whole at roughly its current level. Continuation of the flat 7% ceiling, however, could result in little benefit or even net costs to tenants if 1985 price experience is more like that of 1984 than like the average over the past six years. That is to say, if 1985 inflation resembles the 1984 rate, all tenants taken together could pay higher rents than they would if there were no stabilization program. This stems, of course, from the fact that prices in the Los Angeles area are currently increasing at a rate considerably below 7%.

4.2.4 Impacts on Landlords

We now turn to the relative impacts of optional rent adjustment formulas on Los Angeles landlords, focusing on changes in their net operating incomes (NOI). As before, the analysis does not attempt to model the long-term impact of such formulas. Rather, it predicts short-term changes in building revenues under two sets of price assumptions. The first uses price changes between 1983 and 1984 to predict trends in the upcoming year; the second bases these predictions on the average annual price increase observed over the period 1977-84.

The landlord survey provides data on rent revenues, operating costs, and net operating incomes in 1983, not in 1984. Therefore, we have applied the optional adjustment factors (based on both of the two assumptions of next year's price trends) to yield estimates of 1984 revenues, operating costs, and net operating

EXHIBIT 4-13

AVERAGE 1985 RENT SAVINGS UNDER ALTERNATIVE ADJUSTMENT FORMULAS

	<u>7%</u>	<u>CPI</u>	<u>Non-Shelter CPI</u>	<u>% CPI</u>	<u>Cost-Based</u>
<u>Based on Imputed Rent</u>					
Current Prices	-5	6	9	13	14
Average Trends	17	13	15	26	27
<u>Based on Market Rent</u>					
Current Prices	3	14	17	21	22
Average Trends	26	22	24	35	36

incomes. The procedure for generating these estimates was comparable to the procedure employed in estimating tenant rents under optional formulas. Rents from non-moving tenants were assumed to rise by the full amount of the allowable rent increase; rents in vacated units were assumed to rise by the same amount that was used in the tenant analysis;¹⁵ and the proportion of units that turn over was assumed to be constant across formulas and over time, and equal to the rates which were reported in the landlord survey. Finally, in order to estimate NOI, operating costs were assumed to rise by the amount predicted by the 1984 Price Index of Operating costs constructed for this study and described earlier in this Chapter.

Naturally, this methodology involves most of the same limitations encountered in the tenant analysis. The most concerning of these is that the markup charged for newly occupied units might be higher when rent adjustments are small and lower when rent adjustments are more generous. Thus, our estimates could overstate the differences between the rents yielded by different formulas. In addition, changes in adjustment formulas may, over several years, lead to changes in mobility rates. These effects are not simulated in our analysis, so that the projection could tend to overstate the differences between the effects of different formulas.

Exhibit 4-14 presents the average change in revenues and NOI under each rent adjustment formula, as well as operating expense-to-income ratios using both current and average price trends. Naturally, formulas that limit rent increases to the smallest increments from the tenants' perspective allow the least revenue growth from the landlords' perspective. Thus, using current price trends, the current 7% ceiling yields the greatest revenue gain, while the Cost-Based Index formula yields the smallest. All of these formulas result in reduced operating cost-to-income ratios, because revenues rise more rapidly than operating costs. This stems from the fact that rents are now marked up when units are vacated by larger margins than the rents that can be charged to in-place tenants under any of the formulas. This raises the

EXHIBIT 4-14

IMPACTS OF ALTERNATIVE RENT ADJUSTMENT FORMULAS
ON LOS ANGELES LANDLORDS

	<u>Total Revenues</u>	<u>Operating Costs + Income</u>	<u>Net Operating Income</u>
1983 Values	\$3,359	41.4%	1,966
<u>1984 Current Price Estimate</u>			
7%	+9.34%	39.3%	+13.40%
CPI	+6.49%	40.4%	+8.51%
Non-Shelter CPI	+5.88%	40.6%	+7.48%
%CPI	+4.68 %	41.0%	+5.43%
Cost-Based	+4.47%	41.1%	+5.07%
<u>1984 Average Trend Estimate</u>			
7%	+9.34%	39.3%	+13.40%
CPI	+10.33%	39.0%	+15.06%
Non-Shelter CPI	+ 9.68%	39.2%	+13.94%
%CPI	+ 6.94%	40.2%	+9.26%
Cost-Based	+6.67%	40.3%	+8.95%

overall average increase beyond the rate of price or cost inflation. If the markup charged for newly occupied units were to decline, average rents would, of course, increase more moderately, and operating expense-to-income ratios would be higher. Using the average change in prices over the period 1977-84, the CPI formula allows the greatest revenue gains, while the Cost-Based Index Formula is again the most restrictive.

Exhibit 4-15 presents changes in revenues and net operating incomes under optional rent adjustment formulas for different types of Los Angeles landlords. Properties are grouped by date of purchase, owner residence, building size, and location (LMPA). These estimates rely on current (i.e., 1984) price trends. As in our earlier tenant analysis, the rent adjustment formulas themselves do not vary by building or landlord type. However, tenant turnover rates, recent mover markups and the rate of increase in operating costs do vary.¹⁶ Thus, the magnitude of revenue and NOI changes will differ by group, but the ranking of relative attractiveness of the optional formulas would be expected to be the same for all landlords.

To illustrate, using current price trends, the current 7% ceiling yields the greatest revenue increase for all landlords, while the Cost-Based Index formula yields the smallest. Among the biggest gainers under both formulas are owners of properties with six to eleven units.¹⁷ These properties exhibit higher than average turnover rates, combined with large markups for new tenants. By contrast, properties with five or fewer units tend to have lower turnover rates as well as lower markups. Therefore, these properties experience lower income gains under all rent adjustment formulas. Both of these types of properties experienced roughly comparable increases in operating costs, so that their NOI changes mirror their revenue changes. However, properties with below average cost increases -- such as those with 12 or more units -- may experience NOI growth considerably in excess of revenue growth.

EXHIBIT 4-15

IMPACTS OF ALTERNATIVE FORMULAS ON
LOS ANGELES LANDLORDS BY PROPERTY TYPE

	<u>1983</u>		<u>Change in Revenues</u>					<u>Change in NOI</u>				
	<u>Revenues</u>	<u>NOI</u>	<u>7%</u>	<u>CPI</u>	<u>Non-Shltr CPI</u>	<u>% CPI</u>	<u>Cost- Based</u>	<u>7%</u>	<u>CPI</u>	<u>Non-Shltr CPI</u>	<u>% CPI</u>	<u>Cost- Based</u>
Date of Purchase												
Pre 1978	\$3,275	\$1,973	9.13%	6.27%	5.67%	4.47%	4.26%	12.64%	7.90%	6.90%	4.92%	4.57%
Since 1978	\$3,645	\$2,078	9.62%	6.75%	6.14%	4.94%	4.73%	14.45%	9.42%	8.36%	6.25%	5.88%
Owner Residence												
At Property	\$3,063	\$1,588	9.59%	6.73%	6.12%	4.92%	4.71%	14.97%	9.44%	8.28%	5.96%	5.55%
Elsewhere	\$3,455	\$2,089	9.63%	6.77%	6.16%	4.96%	4.75%	13.56%	8.82%	7.82%	5.83%	5.48%
Building Size												
< 5 Units	\$3,245	\$1,896	8.88%	6.03%	5.43%	4.23%	4.02%	12.19%	7.32%	6.28%	4.24%	3.88%
6-11	\$3,324	\$1,990	12.10%	9.17%	8.55%	7.32%	7.10%	17.26%	12.37%	11.33%	9.28%	8.92%
12+	\$3,731	\$2,134	8.74%	5.90%	5.30%	4.10%	3.89%	12.89%	7.92%	6.87%	4.78%	4.41%
LMPA												
1	\$2,769	\$1,395	10.98%	8.08%	7.46%	6.25%	6.03%	18.22%	12.46%	11.24%	8.83%	8.40%
2	\$2,405	\$1,284	11.96%	9.03%	8.41%	7.19%	6.97%	19.01%	13.53%	12.37%	10.07%	9.66%
3	\$3,352	\$1,848	9.92%	7.04%	6.43%	5.23%	5.02%	15.03%	9.82%	8.72%	6.53%	6.15%
4	\$3,815	\$2,267	9.12%	6.27%	5.66%	4.47%	4.26%	12.75%	7.95%	6.94%	4.92%	4.57%
5	\$4,527	\$3,030	8.13%	5.31%	4.71%	3.52%	3.32%	10.47%	6.25%	5.36%	3.58%	3.27%
6	\$3,257	\$1,578	12.58%	9.63%	9.01%	7.78%	7.56%	20.96%	14.88%	13.60%	11.05%	10.60%

4.2.5 Impacts on Public Tax Revenues

Variations in the formulas used to regulate rent increases affect not only tenant rents and landlord incomes, but public tax revenues as well. This section explores the relative impacts of optional formulas on sales tax revenues, gross receipts tax revenues, and property tax revenues. All tax impacts are measured in relation to the current 7% ceiling on increases. In other words, we begin by calculating the relative savings to tenants (or losses to landlords) from a particular formula as the difference between estimated rents (or building income) under that formula and estimated rents (or building income) under the 7% cap.

There are two important reasons to be concerned that this approach may tend to overestimate the impacts of optional formulas. First, as discussed elsewhere, our analysis assumes that landlords would charge the same proportionate markup for newly occupied units, regardless of the formula in effect. It is possible, however, that landlords would charge a higher markup if stayers' rents were controlled more tightly, while charging a lower markup if stayers' rents were allowed to rise more rapidly. Thus, differences between average rents under alternative formulas may be overstated in our estimates. If so, tax impacts will be overstated as well. In addition, rents under some formulas may be lower than our estimates suggest if Market (or Imputed) Rents act as a constraint on regulated rents in the way discussed earlier in this Chapter. This concern is particularly relevant to the projections that use current price experience to estimate the effects of the 7% ceiling, which would yield average rent increases considerably higher than the 1984 rate of inflation. If the market turned out not to permit maximum allowable increases under these circumstances, then differences between the effects of the 7% cap and those of optional formulas would again be overstated, and tax revenue impacts likewise. Thus, the estimates of changes in public tax revenues developed in this section should be viewed as upper bounds.

We begin by estimating the net change in sales tax revenues that would result from changes in rents. If a particular formula yields an aggregate rent saving to tenants (relative to the 7% ceiling) of S_i , then tenants will have more disposable income to spend. Not all of this incremental income will be spent, and not all that is spent will be devoted to items that are subject to the sales tax; some will be allocated to food, education, savings, or other untaxed uses. In the United States, households typically spend about 95% of their disposable income, and the majority of respondents in the 1984 tenant survey indicated that incremental income would be first used for taxable commodities, particularly entertainment and automobile expenses. Therefore, we have assumed that 60% of incremental income would be subject to the 6% sales tax. Thus, the change in tax revenues can be estimated as:

$$6\% * 0.60 * S_i,$$

where 6% is the applicable sales tax.

At the same time, however, under such a formula landlord revenues would decrease and landlords would have less disposable income. The reduction in landlords' disposable income would amount to:

$$(1 - t_f) (1B_{tr}) S_i$$

where t_r is the gross receipts tax rate (0.125%) and t_f is the landlord's marginal income tax rate (assumed at 50%). We have assumed that landlords as well as tenants spend about 60% of incremental income on taxable items. Therefore, the net change in sales tax revenues is expressed as:

$$(.06 * 60)[1 - (1-0.50)(1-0.00125)]S_i$$

Exhibit 4-16 presents the sales tax effects of all four new formulas, compared to the current 7% ceiling and using both current and average price trends as a basis for analysis. In most instances, as the Exhibit shows, the effects are positive for the governments involved, which is to say that they would have higher revenue receipts under the new formulas than under the current cap. However, under the all-item and non-shelter CPI formulas, sales tax revenue shrinks if one uses the six-year price trend as

EXHIBIT 4-16

NET EFFECTS OF ALTERNATIVE FORMULAS ON
SALES TAX REVENUES -- RELATIVE TO THE SEVEN PERCENT FORMULA

(In \$ thousands per year)

	<u>CPI</u>	<u>%CPI</u>	<u>Non-Shelter CPI</u>	<u>Cost-Based</u>
Current Price	\$1,163.3	\$1,903.6	\$1,480.6	\$2,009.4
Average Price Trends	-423.0	952.8	-211.5	1057.6

an analytic basis. The net revenue increases result under the other assumptions because landlord spending reductions would be moderated by the fact that a sizeable share of the revenue that they would be losing under a new formula now goes to Federal taxes rather than increasing landlords' disposable income available for spending on taxable items. The revenue shrinkage associated with the CPI and Non-Shelter CPI formulas reflects the fact that those formulas would yield rents that are higher than those allowed by the 7% ceiling if one assumes that 1985 price experience will be like the average over the past six years. Therefore, small net declines in sales tax revenues occur. Note that the estimated sales tax impacts are consistently smaller using average price changes than when using current prices. This again stems from the fact that average CPI increases over the 1977-83 period were close to 7%, while recent price inflation has been much lower.

Moving to the effects on revenue from the gross receipts tax, Exhibit 4-17 presents estimates of the changes that the four optional formulas would make as against continuation of the 7% cap, again based both on current and average price trends. Because the gross receipts tax rate is modest, these revenue impacts are relatively small. In most instances the Exhibit shows that the new formula would reduce government receipts, although both the all-item and the non-shelter CPI formulas would yield small increases if high inflation rates were to return.

Finally, we estimate the impact of optional rent adjustment formulas on property tax revenues. The primary impact of alternative formulas on these revenues will occur at the time the property is sold, since Proposition 13 limits annual increases in the assessed valuation of properties to 2%, except at that time. Therefore, we estimate the change in property values resulting from changing rent levels, and apply this change to the share of properties likely to be sold in the next year.¹⁸

Exhibit 4-18 presents the results of these property tax calculations and Exhibit 4-19 shows the net total change in all three forms of public tax revenues implied by our sales tax,

EXHIBIT 4-17

EFFECTS OF ALTERNATIVE FORMULAS ON
GROSS RECEIPTS TAX REVENUES -- RELATIVE
TO THE SEVEN PERCENT FORMULA

(In \$ thousands per year)

	<u>CPI</u>	<u>%CPI</u>	<u>Non-Shelter CPI</u>	<u>Cost-Based</u>
Current Price	-82.2	-135.0	-105.6	-140.9
Average Price Trends	29.4	-64.56	17.64	-76.32

EXHIBIT 4-18

EFFECTS OF ALTERNATIVE FORMULAS ON
PROPERTY TAX REVENUES -- RELATIVE TO THE
SEVEN PERCENT FORMULA

(in \$ thousands per year)

	<u>CPI</u>	<u>%CPI</u>	<u>Non-Shelter CPI</u>	<u>Cost-Based</u>
Current Prices	-308.2	-504.0	-372.3	-526.4
Average Price Trends	126.1	-308.4	42.0	-332.1

EXHIBIT 4-19

NET EFFECTS OF ALTERNATIVE FORMULAS ON
PUBLIC TAX REVENUES -- RELATIVE TO THE
SEVEN PERCENT FORMULA

(in \$ thousands per year)

	<u>CPI</u>	<u>%CPI</u>	<u>Non-Shelter CPI</u>	<u>Cost-Based</u>
Current Prices	772.9	1264.6	1002.7	1342.1
Average Price Trends	-267.5	578.8	-151.9	649.2

gross receipts tax, and property tax calculations. Due to the low rates of property turnover, the property tax impacts of alternative adjustment formulas are not as large as one might think. Although they are usually negative from the government's standpoint (i.e., the government usually receives less property tax revenue under a new formula) property tax impacts are considerably smaller than the impacts on sales tax revenues. Therefore, we conclude that the formulas imposing the tightest constraints on rents also tend to yield higher tax revenues on most assumptions about future rates of inflation. The total net increase would not be very large as a share of the revenues of the State and local governments involved, but the analysis indicates that the net effect on all these governments taken together would be positive unless inflation rates returned to the high levels where they were a few years ago.

4.3 Analyzing Changes in Vacancy Decontrol Provisions

All previous Chapters and sections of this Report have discussed rent stabilization in the context of the current system in which no regulation is applied to the rent charged a new tenant for a vacant unit. Newly occupied units, which constitute between 15% and 20% of all units, were expected to rent at the 1984 average markup of 14% more than units that had not been vacated. This section considers two alternatives to vacancy decontrol: (1) application of formula adjustment ceilings to all units at all times, regardless of turnover; and (2) application of a 10% cap on rent increases at the point of turnover. We measure the implications of these two alternatives in conjunction with the two adjustment formulas that produced the largest and smallest short-term rent increases in our earlier analysis -- the current 7% ceiling and the Cost-Based Index formula. We begin by examining probable impacts on Los Angeles tenants, and then turn to the consideration of impacts on landlords.

4.3.1 Impacts on Tenants

Exhibit 4-20 presents estimates of monthly average 1985 rents and rent-to-income ratios if (a) the current vacancy decontrol policy were maintained; (b) a 10% cap were applied; (c) the cost-based formula were applied regardless of turnover. And, again, the analysis is performed based on both 1984 and six-year average price assumptions. The same methodology that was employed earlier for estimating the impacts of optional formulas has been used here with only minor modifications.¹⁹

These calculations suggest that either a 10% cap or full cost-based formula controls would result in smaller average rent increases than those generated by vacancy decontrol. Correspondingly, average rent-to-income ratios would be slightly lower under either option to decontrol. Note again that our estimates of recent-mover rents under a system of vacancy decontrol may be excessive in the case of some formulas under some sets of economic circumstances, particularly for formulas that allow higher rent increases for stabilized units. If so, the relative impact of vacancy controls would be smaller than Exhibit 4-20 suggests, particularly if the 7% ceiling were continued.

While breakdowns by household groups are not presented here, it is obvious that the greatest beneficiaries of changes in vacancy decontrol policy would be household groups with high mobility rates. These groups include higher-income renters, young households, households with two to four members, and occupants of large apartment properties.

4.3.2 Impacts on Landlords

Exhibit 4-21 presents comparable data on the implications of vacancy controls for Los Angeles landlords. Using both average and current price trends, we have estimated the impacts of a 10% cap and full formula controls in conjunction with the 7% ceiling and the Cost-Based Index formula. Again, mirroring tenant situation in reverse, both forms of control at turnover yield reductions in the overall rate of the growth in landlord revenues. Nevertheless, operating expense-to-income ratios increase only

EXHIBIT 4-20

IMPACTS OF VACANCY CONTROLS ON LOS ANGELES TENANTS

Current Prices

	<u>No Vacancy Controls</u>		<u>Ten Percent Cap</u>		<u>Full Formula Controls</u>	
	<u>7%</u>	<u>Cost-Based</u>	<u>7%</u>	<u>Cost-Based</u>	<u>7%</u>	<u>Cost-Based</u>
1985 Gross Rent	\$486	\$467	\$477	\$461	\$474	\$455
Percent Change in Gross Rent	9.46%	5.18%	7.43%	3.83%	6.76%	2.48%
Gross Rent-to- Income Ratio	29.9%	28.8%	29.4%	28.4%	29.2%	28.0%

Average Price Trends

	<u>No Vacancy Controls</u>		<u>Ten Percent Cap</u>		<u>Full Formula Controls</u>	
	<u>7%</u>	<u>Cost-Based</u>	<u>7%</u>	<u>Cost-Based</u>	<u>7%</u>	<u>Cost-Based</u>
1985 Gross Rent	\$490	\$480	\$481	\$472	\$478	\$468
Percent Change in Gross Rent	10.36%	8.11%	8.33%	6.31%	7.66%	5.41%
Gross Rent-to- Income Ratio	29.1%	28.5%	28.6%	28.1%	28.4%	27.8%

EXHIBIT 4-21

IMPACTS OF VACANCY CONTROLS ON LOS ANGELES LANDLORDS

Current Prices

	<u>No Vacancy Controls</u>		<u>Ten Percent Cap</u>		<u>Full Formula Controls</u>	
	<u>7%</u>	<u>Cost-Based</u>	<u>7%</u>	<u>Cost-Based</u>	<u>7%</u>	<u>Cost-Based</u>
1984 Revenues	\$3,673	\$3,509	\$3,610	\$3,474	\$3,594	\$3,434
Percent Change in Rent	9.34%	4.47%	7.47%	3.44%	7.00%	2.23%
O&M/R	39.3%	41.1%	40.0%	41.6%	40.2%	42.1%

Average Price Trends

	<u>No Vacancy Controls</u>		<u>Ten Percent Cap</u>		<u>Full Formula Controls</u>	
	<u>7%</u>	<u>Cost-Based</u>	<u>7%</u>	<u>Cost-Based</u>	<u>7%</u>	<u>Cost-Based</u>
1984 Revenues	\$3,673	\$3,586	\$3,610	\$3,594	\$3,509	\$419
Percent Change in Rent	9.34%	6.77%	7.47%	7.00%	4.48%	4.48%
O&M/R	39.32%	40.3%	40.0%	40.2%	41.1%	19.38%

slightly. Landlords of properties with high turnover rates would find their NOIs most sharply curtailed. These would especially include properties purchased since 1978, properties at which the landlord resides, and properties with five to eleven units.

4.4 Differential Rent Adjustments

One of the central findings of our earlier analysis of tenant benefits from rent stabilization (Chapter 2) was that long-term stayers enjoy savings up to almost 15% of the rents they would pay in the absence of rent stabilization, while households that have occupied their units for less than three years may actually be paying 2-4% more than they would in the absence of rent stabilization. This differential has two major causes. First, any system of rent controls that lifts its constraints when units are vacated will naturally result in larger benefits for long-term stayers than for more recent movers. Second, the evidence indicates that in the early 1980s landlords imposed particularly high markups for vacated units. Thus, households who moved in during that period now appear to be paying rents which, on average, are higher than the rents they would face in the absence of rent stabilization.

In conjunction with any of the rent adjustment formulas already considered here, it would be feasible to gradually reduce these disparities in rent savings by implementing a differential system of rent adjustments. Specifically, rents for units that had been continuously occupied for six or more years could be allowed to increase by more than the basic standard, while rent increases for units occupied less than three years could be held below the basic standard. We have been asked to comment on the factors to be taken into account in considering the application of such a differential standard.

The following example illustrates how such a differential system could be implemented in conjunction with the Cost-Based Index formula. Long-term stayers (households with six or more years in their units) could be charged rent increases 2.5% above

the norm, while units containing more recent occupants (less than three years) could be held to increases a half of one percent below the norm. Assuming that about 20% of households would vacate their units during the year, approximately 30% of the continuing occupants would be paying rent increases below the norm and about 43% would be paying increases above the norm. To produce a weighted average permissible rent increase for non-movers of 2.32% (the current maximum upward adjustment that would be allowed under the Cost-Based Index formula), the basic rent increase (i.e., the norm mentioned above) would be 1.33%, with increases of 3.88% allowed for households which had occupied their unit for six or more years and increases of only 0.88% allowed for households who had been resident in their units for fewer than three years.

There are several important features about such a differential rent adjustment system that should be noted. First, it would gradually reduce the existing discrepancies in rent savings, so that it would presumably not be maintained indefinitely. Indeed, the adjustment factors discussed above should equalize the benefits enjoyed by different tenure groups of tenants by the end of five years. Second, however, such a system would not necessarily eliminate all of the financial benefits of rent stabilization to long-tenured groups. If the rent increases allowed under the system remained, on average, lower than the rate of increase in Imputed and/or Market Rents, households that remained in their units would continue to experience rent savings. At the same time, it would be entirely feasible to continue to allow decontrol (or partial decontrol) of rents when units were vacated, thereby allowing landlords to keep their overall rent levels as close as possible to levels in an unregulated market.

Nevertheless, it must be observed that the reduction in relative stabilization benefits effected by a differential standard would fall most heavily on the demographic groups most heavily represented in the long-tenured subgroups of tenants, that is on elderly, single-member households. The chief beneficiaries on the other hand, would be younger households with 2-4 members.

4.5 Implementing Alternative Rent Adjustment Formulas

In considering implementation, it must be noted at the outset that the degree of administrative complexity involved in implementing the five formulas just discussed does not vary much in the short term, but varies greatly if a rent stabilization program is to be administered for at least several years into the future. The chief distinguishing factor on this score is whether the ceiling on permissible adjustments is (a) to be adjusted at all, save by City action without detailed documentation; (b) to be adjusted according to a standard index compiled by an official authority other than the City; or (c) to be adjusted according to updated information on the current economics and finances of Los Angeles landlords and their buildings.

Continuation of a flat ceiling on rent increases (at 7% or at any other level) would involve no greater administrative complexity than is experienced now. Likewise, for the CPI and non-shelter CPI formulas, each year's allowable increase would be calculated from the published CPI figures and administered as a flat ceiling for that year. The other options, however -- percent of CPI and cost-based index -- would require periodic collection and updating of expenditure weights (in the case of the cost-based index) and the ratio of operating costs and cash flow to income. Arguably, this need could be met by using annual data from the California Franchise Tax Board to measure changes in expenditures in the types of properties that this data base includes.

The following sections review possible strengths of the optional approaches, both from a substantive and an administrative perspective.

4.5.1 CPI and Non-Shelter CPI

Two of the candidate formulas tie rent increases directly to the Consumer Price Index: the first to the all-item CPI for the Los Angeles area and the second to the non-shelter portion of the

CPI. As shown in Exhibit 4-9, these two approaches would have produced rent increases over the 1977-1984 period similar on the average to the effects of the 7% ceiling, but quite different from year to year and slightly higher overall. On the other hand, under 1984 price conditions both formulas would permit much more modest rises than 7%. Of the two formulas, the Non-Shelter CPI alternative has somewhat more technical appeal since it avoids the circularity of predicating rent increases on a base that includes the previous year's increase in rents.

The advantage of using the CPI as a base is obvious, in that it is both a readily available and a widely used measure of price increases. Moreover, unlike the flat ceiling approach, tying rents to the CPI would permit them to rise with noticeable increases in costs. Although the 7% ceiling matched the CPI fairly well over the long term, it did not react quickly to offset year-to-year changes in landlord costs. Many observers have pointed out that the highest markups charged to movers occurred when inflation was well above 7%, reflecting landlord attempts to compensate for past and anticipated cost increases. Using the CPI as a base could moderate this impulse and help reduce the differential between rents for vacated and non-vacated units.

Of all of the formulas considered here except continuation of a flat ceiling, the full CPI and Non-Shelter CPI are also clearly the easiest to implement, requiring the calculation of only a single number each year. The price change could be calculated on a point-to-point basis (e.g., September to September) or as the percent change in average prices from one 12-month period to the next.

4.5.2 Percent of CPI

In contrast to the all-item and non-shelter CPI formulas, the Percent of CPI formula is designed to tie rent increases more closely to changes in costs paid by landlords, rather than average price increases experienced by all citizens in the area. Specifically, this approach holds financing costs constant while allowing rents to rise enough to cover the effects of inflation

on operating costs and cash flow (or profit). Based on our survey data, the ratio of operating costs to rents was 41% and the ratio of positive cash flow to rents was 17%. Thus the formula allows rents to rise at the sum of these two percentages, or currently at 58% of the CPI. Given that 84% of the landlords surveyed for this study owned their properties free and clear or had fixed-rate primary mortgages, a formula which, like this one, assumes constant financing costs can be defended. If variable-rate mortgages with five to ten-year calls were to continue prominent in the years ahead, the formula might be varied or differentiated to acknowledge the variability of these costs.

Ways might also be found to minimize the administrative complexity and cost of applying and updating such a formula. Information on the ratio of operating costs to income could be obtained from IREM, although, as shown in Exhibit 4-7 this ratio was lower than the ratio derived from the landlord survey, perhaps reflecting the fact that the IREM data covers the entire metropolitan area. The ratio derived from the FTB data might also be replicable in future years if the City could make an ongoing arrangement with the State to this effect.²⁰

4.5.3 Cost-Based Index

The cost-based index closely resembles the percent of CPI formula, and many of the same strengths and problems apply. The strongest point in favor of a purely cost-based adjustment formula is that overall inflation indices such as the CPI are not designed to measure changes in the costs of operating rental property. Inflation in building operating costs may be well above or below the general inflation rate, and it can be greatly affected by other influences. For example, the 1978 reduction in California property taxes significantly lowered landlords' operating costs during a period of high inflation as registered by the CPI. Since the Cost Index-based approach is designed to capture such effects, it has the advantage of assuring landlords (and tenants) that rent increases reflect actual changes in landlords' costs.

Also, as discussed previously, the price data used in the Index of Operating Cost developed herein are readily available from secondary sources. Indeed, the central criterion set for the selection of price data for this study was that they had to be easily obtainable in order to minimize City costs in updating the index from year to year. To be sure the accuracy of the price data would regularly be at issue. But, for reasons noted above, so would be the accuracy of the CPI as a reflection of landlord costs. This Index, although more complex to compile and update, would offer maximum protection from irrelevance.

¹In deriving these weights, expenditures on other utilities (e.g., telephone) were distributed across these subcomponents in proportion to their relative importance in total utilities.

²This same ratio will also later be used to test rent adjustment formulas which adjust rents based on a fixed proportion of the CPI.

³This is accomplished with the following formula:

$$\text{Allowable Rent Increased} = A * I + B * C$$

where A is the ratio of pre-tax cash-flow to rents, B is the ratio of operating cost to rent, C is the estimated percentage change in operating costs, and "I" is the all-item CPI for the Los Angeles area.

⁴This increase was derived as follows: Rent Increase = (.17)(4.2) + (.41)(3.7)

⁵Schedule E of the FTB data presents information on a larger number of expenditure categories. However, the proportion of properties reporting expenses in categories other than insurance, taxes, and utilities is relatively low. Moreover, the largest expenditure category, which was present in 93% of the records, was for unspecified "other expenditures." As a result, one cannot determine whether properties that did not report a given expenditure -- for example, payroll data -- had no hired employees or if they simply included these expenditures as a part of "other" expenses.

⁶These estimated price increases were derived by (1) rescaling the expenditure weights within each component (e.g., utilities) to sum to one; (2) multiplying each of the revised expenditure weights by the appropriate price increase; and (3) summing the products within each component. This procedure produced a weighted price increase of 3.7% for utilities and 4.6% for "other

expenses."

⁷The annual change in property taxes was set at 2% in every year. However, as we have seen, taxes fell by about 45% between 1977 and 1984. Thus, the figures in the Exhibit do not capture the likely decline in 1978 (the year of the rollback). However, increases in the other years should be relatively close to actual trends.

⁸Specifically, Change in Rent =

$$(.20b + .80i) * (V_{t-1}/R_{t-1}) + (1 + PIOC) * (OC_{t-1}/R_{t-1}) - a(V_{t-1}/R_{t-1})$$

where "b" is the rate on Baa Municipal Bonds; "i" is the interest rate on single-family mortgages; "PIOC" is the estimated percent increase in operating costs; "a" is the estimated increase in property values; and V_{t-1} , R_{t-1} , and OC_{t-1} are beginning of the period property values, rents, and operating costs.

⁹The estimated rates of return for the two large and small "prototype" properties used in the analysis in Chapter 3 (Exhibit 3-1) also proved generally to be above the "fair" rate.

¹⁰The 1985 contract rent for non-movers was estimated by:

$$NMR_{85} = (1 + A_i)R_{84},$$

where A_i is the percent adjustment allowed under the i th formula, and R_{84} is the average 1984 contract rent. The 1985 contract rents for movers was estimated by:

$$MR_{85} = (1 + u) (1 + A_i)R_{84},$$

where u is the average mark-up paid by movers (114% in the sample as a whole). The average contract rent was estimated by:

$$R_{85} = (1-m) NMR_{85} + mMR_{85},$$

where "m" is the mobility rate.

¹¹Our initial intention was to inflate 1984 income by the average annual rate of income growth observed among Los Angeles renters between 1977 and 1984. However, this rate (9.7% on average) seems unreasonably high, given an average annual rate of growth in the CPI of only 7.97% for the 1977-84 period and only 4.2% for 1983-84. Therefore, we have applied the annual rate of change in the Los Angeles CPI to 1984 income. Specifically, for our "current price" formula estimates, we inflated household incomes by 4.20% and for our "average trend" estimates we applied an inflation factor of 7.97%.

¹²In reviewing this Exhibit it will be recalled that "contract rent" refers to the amount that a tenant pays a landlord, which may or may not include a component to defray the cost of utilities. "Gross rent," on the other hand, includes utilities,

whether paid by the landlord or by the tenant. If the landlord pays all utilities out of the rent payment received, then the tenant's contract rent is the same as his/her gross rent.

¹³The reader will recall that both of these permissible increases include the increase that the formula permits the landlord to charge stayers and the markup that they charge to movers, and that both are averaged across the whole population of the household group. This explains the seeming anomaly that a 7% cap can permit an 11.5% average rent increase.

¹⁴In comparing these Imputed and Market Rent estimates to our estimates of rents under optional formulas, one can adopt either of two assumptions regarding the relationship between regulated rents and Market (or Imputed Rents). The first assumption would allow regulated rents to exceed without limit the rents that would prevail in the absence of stabilization, while the second would impose Market (or Imputed) rents as a cap on regulated rents. As discussed earlier, the only formula that exceeds an unstabilized rent constraint is the 7% ceiling using last year's price trends. Exhibit 4-13 presents 1985 benefit estimates based on the assumption that Market (or Imputed) rents therefore do not constrain the rents that may be charged under rent stabilization. Note that the alternative assumption would have been produced the same positive benefits, but no negative benefits. In other words, the negative entries in the table would all be zeros.

¹⁵1984 revenues for units that are not vacated are assumed to be:

$$NVR_{84} = (1 + A_i) * R_{83},$$

where A_i is the percent increase allowed by the i th formula, and R_{83} is the average per unit rent revenue in 1983. Rents in units that are vacated are given by:

$$VR_{84} = (1 + u) (1 + A_i) * R_{83},$$

where u is the same percentage markup used previously. The two 1984 revenue estimates are then combined in a weighted average, where the weights reflect landlord estimates of the share of units vacated over the past year (15.5% for the sample as a whole). This turnover estimate is significantly lower than the 20.4% rate implied by the tenant survey. We opted to use the landlord's turnover estimate in conjunction with their revenue and expense data, while using the tenant's turnover estimate in conjunction with their rent and income data.

¹⁶Specifically, turnover rates were calculated by type of property from the landlord survey, using the ratio of units vacated to total rentable units. Recent mover markups for each type of property were obtained from the tenant survey. Finally, each group's average operating costs were inflated by the 1982-83 PIOC calculated from that group's expenditure weights (see Exhibit

4-2).

¹⁷Properties in the least affluent LMPAs appear to make the greatest revenue gains under all formulas. This appears to be the result of particularly high markups reported by recent movers in these areas.

¹⁸Specifically, assuming that a given formula reduces landlord revenues by L_i (relative to the 7% ceiling), property tax revenues will be reduced by $t_c * B * GRM * L_i$, where t_c is the average property tax rate (1.071987%), B is the share of properties sold annually, and GRM is an average gross rent multiplier obtained from 1984 DAMAR data (9.14). Because turnover rates for Los Angeles properties vary quite substantially from year to year, we have tested both a current rate -- 0.0670 observed in 1984 -- and an average rate -- 0.0797, the 1979-84 average.

¹⁹In simulating the implications of continuous formula control, all rents were allowed to rise by the maximum adjustment amount regardless of occupancy status. In simulating the 10% cap, we allowed rents in newly occupied units to increase 10% over their 1984 levels.

²⁰It should be noted that the ratio of cash flow to income used in our analysis was based on landlord-reported financing costs which included both interest and principal payments. IREM provides no financing data and the FTB data reports interest only. If policy makers do not wish to allow payments to equity to increase with inflation, the ratio will have to be updated by some other means.

CHAPTER 5

ALTERNATIVES AND SUPPLEMENTS TO RENT STABILIZATION

The analysis of the financial benefits and costs of rent stabilization in Los Angeles in Chapter 2 indicated that the system produces significant benefits for some types of tenants, largely according to their relative length of tenure in their units. Although not all long-tenured households are elderly or have low to moderate income, these characteristics are disproportionately represented in the groups that receive most of the subsidy provided through the stabilization program. Their benefits are largely financed by higher-income and younger renters, who often pay rents higher than those likely to have been charged in the absence of rent stabilization. However, subsidy sometimes flows in the opposite direction -- from needy households to ones that are financially better off. About one-quarter of the long-tenured households have annual incomes in excess of \$40,000, while many tenants with less than \$20,000 in family income receive no benefits.

This Chapter responds to our assignment to consider some options to rent stabilization that would deliver similar benefits to the needy and to elderly households irrespective of their incomes. In particular, it examines a number of different programs that could be enacted to increase the affordability of rental housing to low- and moderate-income households and other elderly households within the City. Note that these alternatives can only address equivalent financial benefits. It is assumed that the non-monetizable benefits conferred by the rent stabilization Ordinance -- such as protection against unlawful eviction -- could be retained even if stabilization per se were discontinued.

Four major questions will be addressed in the analysis: (1) who would be eligible for these optional forms of assistance; (2) how the benefits could be distributed; (3) how much subsidy would be required per household and how many households could be served from a given revenue base; and finally, (4) how the requisite funds could be raised. The objective of this analysis is to present some broad parameters that could be used to assess the nature and scope of alternative subsidy programs and funding mechanisms. It does not attempt a detailed look at the relative strengths and weaknesses of these various approaches, or at the numerous ways that each program might be structured.

Several basic constraints on the analysis should be emphasized at the outset. The first relates to the nature of the programs considered. Following consultation with the City's Rent Stabilization Division (RSD), we have restricted our analysis to programs that deal explicitly with housing. Thus, for example, we have not considered options which would attack poverty from the income side (such as a negative income tax or an increase in welfare payments). Similarly, in considering ways to raise the requisite funds, we have uniformly assumed that the tax base will be restricted to rental housing. As a result, we have not considered more broad-based schemes that might extend the funding source to owner-occupants or to other financial flows associated with residential or non-residential real estate. We have also restricted the taxing options to approaches that are consistent with the limitations imposed by Proposition 13. Again, all of these decisions have been made following consultation with the RSD.

The Chapter begins by examining the number of households that would be eligible for alternative assistance, as well as the aggregate level of benefits that they currently receive from rent stabilization. It then examines the nature and the cost of three basic types of programs that could be used to increase the affordability of rental housing: (1) housing vouchers; (2) subsidized new construction (or substantial rehabilitation of rental housing); and (3) conversion of existing properties to low-income

cooperatives or condominiums. The Chapter concludes with an examination of some revenue raising schemes that might be used to finance such programs.

5.1 Program Eligibility and Funding Requirements

Two alternative sets of eligibility requirements (and associated funding levels) will be considered in the analysis. Under the first, eligibility would be restricted to "very low" or "low" income tenants (as defined by HUD) in the rent-stabilized population.¹ In the subsequent discussions, we will call this the "low-income" program. Under the second approach, eligibility would be extended to include moderate-income tenants, plus all other elderly renters. This alternative will be referred to henceforth as the "mixed income" program. Funding levels for each alternative would be determined by the aggregate net dollar benefits currently received by the eligible households from rent stabilization.

Exhibit 5-1 presents information on the two different target groups, and on the aggregate annual benefits that they receive under rent stabilization, with these benefits considered from the standpoint of both of our concepts of unstabilized rent levels. The Exhibit also presents information on the number of households that would be ineligible for assistance using each eligibility criterion and on the net money costs in premiums above unstabilized rents that they incur due to rent stabilization. The first estimate of net benefits/costs in the Exhibit is based on the concept of Imputed Rents, which assumes that, in the absence of rent stabilization, rents in Los Angeles would have increased by the same proportionate amount as they have in surrounding unstabilized areas. The second estimate is based on the concept of Market Rents, which assumes that the rents paid by recent movers in Los Angeles are the same as those that would have been paid by all tenants if there were no rent stabilization. The Exhibit also shows the inclusion and exclusion of elderly households in each grouping.

EXHIBIT 5-1

HOUSEHOLD ELIGIBILITY AND BENEFIT LEVELS

	<u>Eligible Households</u>	<u>Ineligible Households</u>
<u>Low-Income Program¹</u>		
Number of Households (1000s)	244	245
Percent Elderly	19%	8%
Aggregate Benefits (\$1,000,000s)		
Based on Imputed Rents	\$82.9	-\$41.8
Based on Market Rents	\$139.0	-\$33.0
<u>Mixed Income Program²</u>		
Number of Households (1000s)	350	139
Percent Elderly	19%	0%
Aggregate Benefits (\$1,000,000s)		
Based on Imputed Rents	\$128.9	-\$87.5
Based on Market Rents	\$173.4	-\$67.5

-
1. Eligible households include all "very low" and "low" income tenants.
 2. Eligible households include all "very low," "low," and "moderate" income tenants, plus upper-income elderly renters.

The Exhibit shows that if eligibility were restricted to "very low" and "low" income renters, about 244,000 households, or about half of the rent-stabilized households in the City would be eligible for some assistance. The estimated benefits received from stabilization by these households total something in the range of \$83-139 million per year. Conversely, the households that would be ineligible (i.e., households with incomes that are not "low" or "very low" by HUD standards), are estimated to currently pay some \$33-42 million per year in premiums above the rents they would pay if stabilization had never been enacted. It will also be noted that about two-thirds of the elderly households in stabilized units would be eligible under this concept while one-third would not.

Under the mixed-income program, on the other hand, about 350,000 households would be eligible for assistance, or about 72% of the City's rent-stabilized households. The aggregate net benefits estimated to have been received by this larger group from rent stabilization are in the range of \$129-173 million per year. Ineligible households -- which would now consist entirely of upper income, non-elderly tenants -- have been estimated to pay premiums of between \$68 million and \$88 million a year as a result of rent stabilization. No elderly households that are now stabilized would be ineligible for assistance under this concept.

As the Exhibit and the discussion above make clear, delivering equivalent benefits to the members of either group of beneficiaries would involve more dollars than the net subsidy now received by all rent-stabilized tenants because the net benefits received by the households targetted under either eligibility concept would not be offset by the net premiums above unstabilized rents that are paid by the ineligible households. Thus, providing equivalent benefits to the target groups would require a source of funds that would generate something between \$83 million and \$173 million per year, depending upon (1) which concept of eligibility was adopted; and (2) which standard of comparison to unstabilized rent levels was selected.

5.2 Ways to Distribute Benefits

This section explores some alternative approaches which might be used to distribute benefits to eligible households, given the eligibility requirements and funding levels derived above. Three basic approaches have been considered. The first is the introduction of rental subsidies similar to Housing Vouchers. The second is a supply-oriented approach (i.e., subsidized new housing construction or rehabilitation), while the third involves the development of low-income cooperatives. For each of these broad options, we have estimated the average subsidy (or cost) per household. We have also derived the number of households that could be served in any year, assuming the minimum and maximum funding levels of \$83 million and \$173 million per year.

5.2.1 Housing Vouchers

One approach to addressing the housing needs of low-income renters is to introduce a Housing Voucher program comparable to the national Demonstration currently underway. Under such a program, households would be given a subsidy payment equal to the difference between 30% of their income and the cost of a prototypical "modest" rental unit. Households would receive this subsidy regardless of their actual rents, so that the resulting rent-to-income ratios might be different from 30%. Under the terms of the national Demonstration, households must occupy dwelling units that meet certain physical conditions and occupancy standards. However, such standards could presumably be modified if a local program were initiated.²

In examining this program option, we have estimated the cost of a modest unit in two different ways. We begin by using Fair Market Rents (FMRs) as determined by HUD. Such rents are established by examining the gross housing costs of recent movers in standard units (excluding new construction) and are relatively close to the housing costs reported by recent movers in our survey. However, in addition to FMRs, we have used the average Imputed Rents that were derived as part of our analysis of tenant

benefits (and which reflect rents charged in surrounding unstabilized areas). Since recent movers tend to pay more in any market, even in the absence of rent stabilization, the use of average Imputed Rents (based on movers and stayers alike), would tend to reduce the amount of subsidy provided to any household.³

Exhibit 5-2 presents the two alternative monthly standards that have been used in this analysis. Following the procedures employed by HUD, these standards are allowed to vary by bedroom count. The Exhibit shows the way in which different sized households are assigned units of different room sizes for purposes of calculating the prototypical rent against which the 30%-of-income standard is measured. While these household size/room standards are roughly consistent with those employed by HUD, they could again be modified or adapted if a local rent subsidy program were enacted.

Exhibit 5-3 presents estimates of the average subsidies required per household under a number of different assumptions regarding (1) program eligibility; (2) the rent charged for a "modest" unit; and (3) the proportion of income that is selected as the maximum affordability standard (i.e., 30% or 40% of household income). In addition, we have estimated the number of otherwise eligible households that would actually qualify for a voucher because a prototypical unit would cost more than the income share defined as affordable. Again, households are assumed in the Exhibit to qualify if the cost of a modest unit exceeds 30% (or, alternatively, 40%) of their monthly income.

Several broad conclusions can be drawn from the Exhibit. To begin with, extending eligibility beyond the very low and low-income households to families with higher incomes would not produce a significant increase in the number of potential voucher recipients. Under the 30%-of-income criterion, only 6% of moderate-income households would qualify for a housing voucher if subsidies were based on FMRs, and only 2% would qualify if Imputed Rents were used as this basis. No households of this income class would be eligible if the affordability criterion was raised to 40% of income. Similarly, virtually no upper income

EXHIBIT 5-2

COST AND OCCUPANCY STANDARDS FOR A VOUCHER PROGRAM

	COST STANDARDS		OCCUPANCY STANDARDS
	FMRs	Imputed Rents	
Efficiency	\$416	\$323	1 person
One-Bedroom	490	\$406	2 persons
Two-Bedroom	567	\$530	3-4 persons
Three-Bedroom	741	\$701	5-6 persons
Four-Bedroom	851	\$709	7+ persons

EXHIBIT 5-3

AVERAGE SUBSIDY LEVELS UNDER A VOUCHER PROGRAM

	<u>Cost Standard Based on FMRs</u>		<u>Cost Standards Based on Imputed Rents</u>	
	<u>Average Monthly Subsidy¹</u>	<u>Potential Subsidy Recipients + Eligible Households</u>	<u>Average Monthly Subsidy¹</u>	<u>Potential Subsidy Recipients + Eligible Households</u>
Low-Income Program				
Based on 30%	225	100%	188	86%
Based on 40%	213	70%	190	55%
Mixed-Income Program				
Based on 30%	223	71%	186	61%
Based on 40%	212	49%	190	39%
Very Low Income				
Based on 30%	320	100%	249	100%
Based on 40%	254	100%	220	84%
Low Income				
Based on 30%	109	100%	79	68%
Based on 40%	62	34%	38	21%
Moderate Income				
Based on 30%	33	6%	29	2%
Based on 40%	0	0%	0	0
Upper-Income Elderly				
Based on 30%	0	0%	0	0%
Based on 40%	0	0%	0	0%

1. Average subsidy excludes otherwise eligible households whose affordable housing costs exceed the given cost standards.

elderly would be eligible for a voucher regardless of the prototypical rent basis or income share standard employed. As a result, unless one altered the basic cost and affordability standards, eligibility for such a program would be very largely restricted to low and very low-income households.

The second general conclusion is that almost all very low income households would qualify for the program, regardless of the underlying cost and affordability standards employed. However, eligibility rates among low-income households would vary significantly with these factors. All low-income households would qualify for assistance if one employed FMRs in combination with a 30%-of-income affordability standard (the mix that produces the highest overall subsidies and represents the criteria employed by HUD). However, only 21% would qualify if households were measured by whether they devote 40% of their incomes to housing and if the housing cost standards were based on Imputed Rents. The inclusivity of households of modest income under either eligibility standard reflects the fact that low- and very low-income households as a group now pay an average of 39% of their incomes in rent.

The figures in Exhibit 5-3 also clearly illustrate that if vouchers were provided to all those eligible in the amount necessary to make their housing affordable, the subsidies that would flow from such a voucher program would far exceed the net financial benefits that have been provided to the target beneficiaries by rent stabilization. The estimated net monthly benefits currently received from rent stabilization by very low-income households average from \$26 to \$55 per month, compared to subsidies ranging from \$220 to \$320 per month under a housing voucher approach. Similarly, low-income households now save an average of between \$4 and \$24 per month as a result of rent stabilization, compared to estimated voucher subsidies that would range from \$38 to \$109 per month. Finally, while moderate-income households are currently receiving net benefits from stabilization (saving between \$24 and \$27 per month, on average), only a

handful of such households would receive a subsidy if a voucher approach were adopted using eligibility criteria of the kind described herein.

Since funding vouchers of the number and magnitude required to bring the target beneficiary populations within the housing affordability range would cost so much more than rent stabilization provides to these populations in benefits, it follows that if the voucher program were limited to an amount of money equivalent to rent stabilization benefits, either many eligible households would not receive vouchers or all households would receive vouchers much smaller than would be necessary to make their housing costs "affordable." Exhibit 5-4 presents estimates of the number of households that could be fully served (i.e., brought into the affordability range by vouchers) in any year, assuming funding levels (\$83 and \$173 million per year) set at the minimum and maximum measures of net rent stabilization benefits. Note that the "high" funding level is based on the benefits received from stabilization by moderate-income as well as lower-income households, plus all elderly tenants. As we have seen, extending nominal voucher eligibility to moderate-income households does not produce a large increase in the number of households that would actually qualify for a voucher under a voucher program following these affordability rules. Nevertheless, we have included this funding level in the analysis to illustrate the number of eligible households that could be fully served if a larger program were adopted.

Because the average fully served participant would need to receive a subsidy ranging from about \$2,256 to \$2,700 a year (depending on the cost and affordability standards employed), the Exhibit shows that a "small" voucher program (i.e., one costing \$83 million a year) could fully support about 31,000 to 37,000 households. This represents between 13% and 27% of all of the households that would qualify for a voucher. If a larger program were adopted, the number that could be fully served would be approximately doubled. If all of the program money were directed to very low- and low-income households, between 65,000 and 75,000

EXHIBIT 5-4

MAXIMUM NUMBER OF PARTICIPANTS
PER YEAR IN A VOUCHER PROGRAM

	Small Program (\$83 million)				Large Program (\$173 million)			
	Based on FMRs		Based on Imputed Rents		Based on FMRs		Based on Imputed Rents	
	<u>30%</u>	<u>40%</u>	<u>30%</u>	<u>40%</u>	<u>30%</u>	<u>40%</u>	<u>30%</u>	<u>40%</u>
<u>Low Income Program</u>								
Potential Voucher Recipients ¹ (1000s)	244	171	210	134	244	171	210	134
Number Issued (1000s)	31	32	37	36	65	67	77	75
Percent Served	13%	19%	18%	27%	27%	39%	37%	56%
<u>Mixed Income Program</u>								
Potential Voucher Recipients ¹ (1000s)	249	172	214	137	249	172	214	137
Number Issued (1000s)	31	33	37	36	65	68	78	76
Percent Served	12%	19%	17%	26%	26%	40%	36%	55%

1. Potential subsidy recipients are less than the number of target households, since some eligible households do not require a housing voucher.

households could be fully served, representing between 27% and 56% of all those eligible. Of course, if funding were entirely constrained to the net number of dollars now delivered by rent stabilization to the target beneficiaries, it might be decided that it would be better for all eligible households to receive some subsidy than for a few to receive full subsidy. If so, more households could be served, but only at a fraction of the level necessary to bring them into the affordability range.

However, in interpreting these statistics, it is also important to recognize that experience in programs of the voucher type indicates that not all eligible households would be likely to participate in a voucher program, even if it offered open-enrollment. For example, in the early 1970s, a large-scale voucher program was initiated on a demonstration basis in 16 metropolitan areas. This program -- called the Experimental Housing Allowance Program (EHAP) -- registered participation rates that ranged from about 40% of eligible households if minimum quality standards were imposed, to about 80% of eligible households if the grant were unrestricted.⁴ Participation rates in a local program would undoubtedly depend on a variety of factors, including the size of the rental subsidy, the stringency of quality standards and the method of outreach to potential participants. Nevertheless, there is reason in history to expect some shortfall between the actual and the theoretical numbers of applicants for vouchers, so that the fraction of applicants that could be fully or partially served at any level of funding might be noticeably larger than suggested by the figures in the Exhibit.

In sum, therefore, analysis of the voucher option indicates that, although vouchers could be used to help reduce the unstabilized rents of target beneficiary groups, limiting the total value of the vouchers to the number of dollars now saved by these groups through rent stabilization would mean that only a small minority of them could be subsidized to the point where they could afford the unstabilized rents that they would then be required to pay. Since many households in these groups cannot "afford" the rents they are now in fact paying (i.e., they are

now paying more than 30-40% of their income for housing), the sponsors of a new voucher program might want to establish different affordability criteria than have been used elsewhere, or set a program objective that was not based on a share-of-income standard. Nevertheless, the analysis suggests that any voucher program conceived along the lines of past national experiments would need to choose between quite modest program goals and a substantially higher level of funding than could be provided simply by matching the current net flow of money benefits from rent stabilization.

5.2.2 New Construction

Another broad option to rent stabilization would be to subsidize new construction (or substantial rehabilitation) of housing in the City of Los Angeles. While such supply-oriented approaches are typically more expensive than housing vouchers, they serve to increase the housing stock, and thus may be relatively effective in tight housing markets. Accordingly, this section examines the number of households that could be served if such a program were initiated, as well as the average subsidy required. Several types of subsidies are considered, including: (1) an up-front construction grant; (2) an interest-rate subsidy; or (3) a rental supplement similar to that described in the previous section.

In order to make these calculations, we first had to estimate the average cost of a newly constructed unit. These estimates are presented in Exhibit 5-5, and range from \$44,000 for a new efficiency to \$80,000 for a newly constructed four-bedroom unit.⁵ We also had to estimate the mortgage terms that would be faced by project developers. Based on conversations with local lenders, we assumed an 11.5% variable-rate mortgage with a 30-year term and a 15% down payment. Finally, we had to estimate the monthly costs of operating the unit. Here, we used the average operating and maintenance expenditures that were reported in the landlord survey, updated to 1984 dollars (\$122 per unit per month). We also assumed that households pay an additional \$43 a

EXHIBIT 5-5

ESTIMATED NEW CONSTRUCTION COSTS

	Development Costs	Monthly Costs ¹
Efficiency	\$44,000	\$535
One-Bedroom	\$53,000	\$611
Two-Bedroom	\$62,000	\$687
Three-Bedroom	\$69,000	\$746
Four-Bedroom	\$80,000	\$838

1. Monthly costs include the sum of building operating and maintenance costs (\$122) mortgage payments, (at market rates), and tenant utility payments (\$43). Mortgage payments were derived by assuming a 30-year term, a 15 percent downpayment, and an 11.5 percent interest rate.

month for utilities (the average derived from the tenant survey). While these assumptions are necessarily crude, the figures presented below should help to define the broad parameters of a supply-oriented approach.

Three types of subsidies have been analyzed. The first is an up-front construction grant, which would be used to reduce the mortgage and, hence, the requisite financing costs. The size of the grant was derived by first calculating the project's net operating costs assuming that households paid 30% (or, alternatively, 40%) of their incomes on housing (including utilities). We then estimated the mortgage amount that could be supported within this "affordable" net operating income (NOI) level, assuming the market interest rate. The difference between this "affordable" mortgage amount and the one that was actually required was then used to determine the size of the construction grant necessary to provide the incentive required to get the unit constructed.

The second option considered is a below-market interest rate loan, which would serve to bring financing costs in line with the "affordable" NOI. The subsidized interest rate is derived by taking the mortgage amount (at full market value) and finding the rate that would equate NOI and financing costs (again assuming a 30-year term).

The final option considered is a rental supplement. This approach does not subsidize new development directly; rather, similar to some existing Federal programs, the program would encourage private construction on unsubsidized terms by supplementing the income streams tenants. The size of the rent supplement was set equal to the difference between the landlord's mortgage payment (at full market rates) and the "affordable" NOI that would result when the landlord's costs were subtracted from the amount that the tenant could afford to pay before being subsidized.

The results of these calculations are provided in Exhibit 5-6, which presents information on the average cost of newly constructed units, the average mortgage amount (at 85% of devel-

EXHIBIT 5-6

NEW CONSTRUCTION SUBSIDIES

	HUD CLASSIFICATION					
	<u>Low Income Program</u>	<u>Mixed Income Program</u>	<u>Very Low Income</u>	<u>Low Income</u>	<u>Moderate Income</u>	<u>Upper Income Elderly</u>
Average Cost (Price)	\$54,187	\$53,078	\$54,392	\$53,939	\$50,658	\$49,029
Mortgage	\$46,059	\$45,116	\$46,233	\$45,848	\$43,059	\$41,675
Rent Supplement ¹						
30% Income	334	280	425	223	72	0
40% Income	240	241	359	95	0	0
Construction Grant						
30% Income	33,696	24,818	42,911	22,511	4,701	0
40% Income	24,064	16,802	36,250	9,274	0	0
Maximum Interest Rate (@ 30 years)						
30% Income	N/A	3.44%	N/A	4.45%	10.07	11.50
40% Income	3.9%	6.33%	N/A	8.79%	11.50	11.50
Number of Eligible Households	244,000	350,000	134,000	110,000	96,000	10,000
Proportion Requiring Subsidy						
30% Income	100%	88%	100%	100%	65%	0%
40% Income	99%	69%	100%	97%	0%	0%

1. Excludes households with zero subsidies.

opment costs), and the average subsidies that would be required in order to bring the costs of these units in line with what the target households could afford to pay. Once again, we have used two affordability standards in making these calculations, as well as two different eligibility criteria.

The Exhibit shows that when participation is restricted to low- and very low-income households (see the first column), the average unit would cost a bit more than \$54,000 to develop, of which about \$46,000 would be mortgage-financed. Using the 30% affordability criterion, the average unit would require a rental supplement of about \$334 per month to a tenant from one of these income groups. Alternatively, a construction grant of about \$34,000 would be required to bring the rent within reach of such a tenant without supplementing the income of the household. As for the subsidization of the interest rate on the mortgage, the Exhibit indicates that even if the City were to bring the rate to zero -- making construction of the unit interest-free -- new construction would still not be a viable option to house the average eligible household. Thus, pure interest subsidy would not be an efficacious subsidy option. Moving on down the column, the Exhibit shows that 244,000 households would be eligible to participate in this program, and that all of them would require subsidies if they did.

When the affordability standard is increased to 40%, the requisite subsidies fall. However, the average construction grant would still have to be about 44% of development costs in order to make the average unit affordable to the average eligible participant. Alternatively, the city would need to provide a 30-year below-market mortgage loan at about 3.9% or a rental supplement of about \$240 per month. Virtually none of the eligible households in this "Low Income" group of eligibles could afford to pay the rents necessary to support the true, unsubsidized cost of the project (defined as the sum of operating and financing costs), regardless of the affordability standard employed.

The depth of the average subsidy required would be reduced at least somewhat if moderate-income households (and upper-income elderly) are assumed to participate in the program (see the second column of the Exhibit). About 35% of moderate-income households would not qualify for a subsidy, using a 30%-of-income affordability standard. None of these households would qualify for a subsidy if a 40% standard were employed. Similarly, no upper-income elderly households would qualify, again regardless of the affordability standard. Those households who would not qualify for subsidies are excluded from the calculations that underlie the rent supplement estimates in the Exhibit. The averages shown are only for the households that would qualify. It will be noted that within this concept of overall program eligibility it becomes much more important whether one employs the 30% or the 40% share-of-income affordability criterion.

Assuming that a project contains a representative mix of low- and moderate-income households, the 30% affordability criterion would lead to an average construction grant of \$24,818 per unit, or a subsidized interest rate of about 3.4%. If a rent-supplement approach were adopted, the average unit would have a monthly subsidy of \$280 if the 30% criterion were used, or \$241 if one adopted the 40% standard. The subsidized interest rate would range from about 3.4% to about 6.3%, depending upon the affordability criterion used.

Having analyzed what it would cost per unit to bring new construction within the affordable range for the target beneficiary groups, Exhibit 5-7 presents estimates of the number of new units that could be supported under a new construction program that might be financed by an amount equivalent to the net benefits received by these groups from rent stabilization. As before, two funding levels have been examined, representing expenditures of \$83 million and \$173 million a year, respectively. Note that with up-front construction grants, the number of units developed would increase over time (assuming continuation of the

EXHIBIT 5-7

SUBSIDIZED CONSTRUCTION ACTIVITY

	Small Program (\$83 Million)		Large Program (\$173 Million)	
	<u>30% Income</u>	<u>40% Income</u>	<u>30% Income</u>	<u>40% Income</u>
<u>Low-Income Program</u>				
Construction Grants				
Per Year	2,500	3,500	5,200	7,300
Five-Year Total	12,500	17,500	26,000	36,600
Rent Supplements/ Below-Market Loans	20,700	29,000	43,300	60,700
<u>Mixed-Income Program Without Rent Skewing</u>				
Construction Grants				
Per Year	3,300	4,900	7,000	10,300
Five-Year Total	16,700	24,600	35,000	51,500
Rent Supplements/ Below-Market Loans	28,100	41,600	58,700	87,000
<u>Mixed-Income Program With Rent Skewing</u>				
Constructions Grants				
Per Year	3,600	8,500	7,600	17,700
Five-Year	18,200	42,300	38,000	88,500
Rent Supplements/ Below Market Loans	30,600	71,200	64,000	149,000

program). As a result, in addition to presenting estimates of the annual number of units that could be developed with such grants, we have also presented cumulative five-year totals.

The Exhibit indicates that if the construction program were restricted to low-income households -- and if funding were set at \$83 million a year -- construction grants could support between 2,500 and 3,500 units a year, depending on the affordability standard employed. Below-market loans or rent supplements would support between 21,000 and 29,000 units a year. Due to the higher costs of new construction, these program levels are well below those estimated to result from a voucher approach, which could support between 31,000 and 37,000 households a year with the same basic funding level. If funding were to rise to \$173 million, the Exhibit shows that construction output would approximately double.

If the program were expanded to moderate-income households -- and if each project contained a representative mix of low- and moderate-income tenants -- the number of units that could be built would increase significantly. Construction grants could be used to support between 3,300 and 4,900 units a year under the smaller program (\$83 million). Similarly, between 28,100 and 41,600 households could be supported with rent supplements or below-market loans. Although these figures are close to those derived in the housing voucher option, not all participating households would need a subsidy to live in these units. Using a 30% criterion, 12% of the project's tenants would be market-rate; with a 40% criterion, this share would increase to 31%. As a result, the number of subsidized households supported by such a program would range from 24,700 to 28,700.6

5.2.3 The Development of Low- and Moderate-Income Cooperatives

The final option considered here is the conversion of rental properties to low- or moderate-income cooperatives (or condominiums). Once again, we consider three ways to subsidize such developments: (1) an upfront grant; (2) an interest-rate subsidy;

or (3) a monthly supplement for housing costs. The basic calculations are identical to those described in the previous section. However, instead of new construction prices, we have used the average values of rental properties as reported in the landlord survey. Exhibit 5-8 shows the sales prices and average costs used in this analysis.⁷ We have also assumed that the household makes a down payment of 3%. The remaining assumptions about interest rates, utility costs, and other building operating and maintenance costs are the same as those employed in the analysis of new construction.

Exhibit 5-9 presents estimates of the proportion of eligible households who would be financially able to participate in a coop-conversion program, and of the proportion that would require some kind of subsidy to do so. These statistics are presented for all households that are eligible under each criterion, as well as for the individual income groups. If, under the applicable share-of-income criterion the household can afford to pay all operating and financing costs at current interest rates, the household is shown as "market rate." All remaining households are assumed to require a subsidy in order to participate in the program. Note that our estimates have all been based on the household's current income. Since we do not have information on accumulated wealth, we are unable to estimate the ability of households to meet the down payment requirement or, at the other extreme, to reduce their monthly payments by reducing the size of their loan.

When eligibility is restricted to very-low and low-income households (first column), all of the target population would require subsidies in order to participate. The incomes of 21% of such households could not fit even the operating costs of the unit within the 30% affordability criterion. All of the remaining 79% would require subsidy to carry the financing costs. Put another way, using a 30% affordability standard, none would be "market rate." Using a 40% criterion, however, 25% of the target beneficiary group would not require a subsidy. As can be seen,

EXHIBIT 5-8

ESTIMATED COOPERATIVE COSTS

	<u>Sales Price</u>	<u>Monthly Costs</u> ¹
Efficiency	\$29,000	\$444
One-Bedroom	\$35,000	\$501
Two-Bedroom	\$41,000	\$559
Three-Bedroom	\$45,000	\$597
Four-Bedroom	\$52,000	\$665

1. Monthly costs include the sum of building operating and maintenance costs (\$011), utility payments (\$43), and financing costs (assuming a 30-year term, a three percent down payment, and an 11.5 percent interest rate).

EXHIBIT 5-9

SUBSIDY NEEDS IN LOW- AND MODERATE-INCOME COOPERATIVES

(3% Down Payment)

	HUD CLASSIFICATION					
	<u>Low Income Program</u>	<u>Mixed Income Program</u>	<u>Very Low Income</u>	<u>Low Income</u>	<u>Moderate Income</u>	<u>Upper Income Elderly</u>
<u>30% Affordability Criteria</u>						
% Requiring Operating Cost Subsidy ¹	21%	14%	38%	0%	0%	0%
% Requiring Financing Cost Subsidy Only ²	79%	61%	62%	100%	21%	0%
% Market Rate	0%	25%	0%	0%	79%	100%
<u>40% Affordability Criteria</u>						
% Requiring Operating Cost Subsidy ¹	5%	3%	9%	0%	0%	0%
% Requiring Financing Cost Subsidy Only ²	71%	50%	91%	47%	0%	0%
% Market Rate	24%	47%	0%	53%	100%	100%

1. Households in this group cannot afford to cover the monthly operating and maintenance costs at \$165 per month.

2. Households in this group can afford to pay monthly operating and maintenance costs, but require a subsidy to cover financing costs at market rate.

when one extends eligibility to moderate income households, as well as upper-income elderly, a larger proportion of the target group would be able to pay market rates.

Exhibit 5-10 presents estimates of the average subsidies that would be required in order to support a low or mixed income cooperative. In estimating these subsidies, we assumed a 3% down payment and that households whose income could not support the unit's operating costs would not be excluded from the program for that reason. We also ruled out inter-project transfers. In other words, we assumed that "market" rate households would not help to subsidize the housing costs of poorer residents and that, as a result, their monthly housing costs would be equal to the sum of operating and financing costs (at market rates).

If the program were restricted to very low- and low-income tenants, the average unit would require an up-front grant of between \$14,000 and \$22,000, or a below-market loan at between 1.6% and 5.7%. If a rental supplement were used, it would average between \$188 and \$221 per month.

If program eligibility were extended to all elderly or moderate- income households -- and again, its projects contained a representative mix of the different income classes -- average subsidy levels would decline. This pattern reflects the fact that "market rate" families would represent between 34% and 55% of all participants, and could thus bear a larger proportion of the cooperative's costs. The average monthly subsidy under such a program would range from \$188 to \$205 a unit (excluding those with zero subsidies). Alternatively, the average up-front grant would range from \$10,000 to \$15,600, while the subsidized interest rate would range from 5% to 7.4%. Exhibit 5-11 shows the results if one excluded from the calculations households whose incomes would not carry even the operating costs of the unit.

Exhibit 5-12 presents estimates of the number of cooperatives that could be developed within the total net savings estimated to accrue to the beneficiary groups from rent stabilization. Again, two definitions of program eligibility and two different funding levels are used. If eligibility were restric-

EXHIBIT 5-10

SUBSIDIES REQUIRED FOR COOPERATIVES ¹

(Including Very-Low Income Households)

	HUD CLASSIFICATION					
	<u>Low Income Program</u>	<u>Mixed Income Program</u>	<u>Very Low Income</u>	<u>Low Income</u>	<u>Moderate Income</u>	<u>Upper Income Elderly</u>
Average Purchase Price	\$35,724	\$34,999	\$35,834	\$35,590	\$33,418	\$32,353
Average Mortgage	\$34,652	\$33,949	\$34,359	\$34,523	\$32,416	\$31,382
Monthly Housing Cost Supplement ²						
30% Income	\$221	\$205	\$311	\$111	\$8	0
40% Income	\$188	\$188	\$245	\$40	0	0
Up-front Grant						
30% Income	\$22,289	\$15,606	\$31,437	\$11,186	\$157	0
40% Income	\$14,434	\$10,078	\$24,776	\$1,881	0	0
Maximum Affordable Interest Rate ² (@ 30 years)						
30% Income	1.6%	5.0%	N/A	7.0%	11.5%	11.5%
40% Income	5.7%	7.4%	0.2%	10.8%	11.5%	11.5%
Percent of Eligible Households Requiring a Subsidy						
30% Income	100%	75%	100%	100%	21%	0%
40% Income	76%	53%	100%	\$&%	0%	0%

1. Includes very low-income households who cannot cover operating and utility costs at 30 (or 40) percent of their income.

2. Excludes households with zero subsidies.

EXHIBIT 5-11

SUBSIDIES REQUIRED FOR COOPERATIVES ¹

	HUD CLASSIFICATION					
	<u>Low Income Program</u>	<u>Mixed Income Program</u>	<u>Very Low Income</u>	<u>Low Income</u>	<u>Moderate Income</u>	<u>Upper Income Elderly</u>
Average Purchase Price	\$35,845	\$34,976	\$36,182	\$35,590	\$33,418	\$32,353
Average Mortgage	\$34,770	\$33,906	\$35,096	\$34,523	\$32,416	\$31,382
Monthly Housing Cost Supplement ² (excludes market rate)						
30% Income	\$177	\$162	\$265	\$111	\$8	0
40% Income	\$173	\$173	\$229	\$40	0	0
Up-front Grant						
30% Income	\$17,896	\$11,634	\$26,775	\$11,186	\$157	0
40% Income	\$12,551	\$8,969	\$23,125	\$1,881	0	0
Maximum Affordable Interest Rate (@ 30 years)						
30% Income	4.1%	6.8%	N/A	7.1%	11.5%	11.5%
40% Income	6.3%	7.9%	1.2%	10.8%	11.5%	11.5%
Percent of Eligible Households Requiring a Subsidy						
30% Income	100%	71%	100%	100%	21%	0%
40% Income	75%	51%	100%	47%	0%	0%

1. Excludes very low-income households who cannot cover operating and utility costs at 30 (or 40) percent of their income.

2. Excludes households with zero subsidies.

EXHIBIT 5-12

ACTIVITY UNDER A COOPERATIVE CONVERSION PROGRAM

(Including All Very-Low Income Households
and Assuming a 3% Down Payment)

	<u>Small Program</u> <u>(\$83 Million)</u>		<u>Large Program</u> <u>(\$173 Million)</u>	
	<u>30%</u> <u>Income</u>	<u>40%</u> <u>Income</u>	<u>30%</u> <u>Income</u>	<u>40%</u> <u>Income</u>
<u>Low-Income Program</u>				
Number of Grants				
Per Year	3,700	5,800	7,800	12,000
Five-Year Total	18,500	29,000	39,000	60,000
Number of Below-Market Loans/Housing Cost Supplements				
Subsidized	31,300	36,800	65,200	76,600
Market Rate	0	11,600	0	24,200
TOTAL	31,300	48,400	65,200	100,800
Number of Eligible Households	244,000	244,000	244,000	244,000
<u>Mixed Income Program</u>				
Number of Grants				
Per Year	5,300	8,200	11,100	17,200
Five-Year Total	26,500	41,000	55,500	86,000
Number of Below-Market Loans/Housing Cost Supplements				
Subsidized	33,700	36,800	69,800	76,400
Market Rate	10,900	32,400	23,200	67,800
TOTAL	44,600	69,200	93,000	144,200
Number of Eligible Households	350,000	350,000	350,000	350,000

ted to very low- and low-income households (not excluding those who would not carry the operating cost without subsidization -- and if funding were set at \$83 million a year -- between 3,700 and 5,800 grants could be supported every year. If eligibility were extended to moderate-income households, the production figures would approximately double. Again, this reflects the fact that a greater proportion of units would be market rate, thus reducing the average subsidy that is required for the group as a whole. Exhibit 5-13 shows a similar breakdown if one assumes that households which could not carry the operating cost without subsidy would be unable to participate.

5.2.4 Comparison of All Options Considered

Exhibit 5-14 compares all of the options presented heretofore. For both the "low income" and "mixed income" sets of eligibility assumptions, it shows the total rental subsidy and the total number of subsidized and unsubsidized units that could be financed under a "small" alternative assistance program (i.e., one that would cost \$83 million per year), and a "large" program (one that would cost \$173 million per year). These dimensions are, of course, the minimum and maximum estimates of net benefits to the target beneficiary groups that are now delivered through stabilization of their rents. The Exhibit also breaks down the figures according to whether the affordability standard selected is 30% or 40% of tenant income spent on shelter.

5.3 Alternative Funding Mechanisms

This section examines a series of alternatives for raising funds for housing assistance. The alternatives that have been identified for consideration fall into two basic groups. The first consists of funding mechanisms that would replace rent stabilization, while the second consists of mechanisms that would supplement the existing stabilization system. None of the op-

EXHIBIT 5-13

ACTIVITY UNDER A COOPERATIVE CONVERSION PROGRAM ¹

(Excludes Very-Low Income Households)

	<u>Small Program</u> <u>(\$83 Million)</u>		<u>Large Program</u> <u>(\$173 Million)</u>	
	<u>30%</u> <u>Income</u>	<u>40%</u> <u>Income</u>	<u>30%</u> <u>Income</u>	<u>40%</u> <u>Income</u>
<u>Low-Income Program</u>				
Number of Grants				
Per Year	4,600	6,600	9,700	13,800
Five-Year Total	23,000	33,000	48,500	69,000
Number of Below-Market Loans/Housing Cost Supplements				
Subsidized	39,100	40,000	81,500	83,300
Market Rate	0	13,600	0	28,500
TOTAL	39,100	53,600	81,500	111,800
Number of Eligible Households	193,000	232,000	193,000	232,000
<u>Mixed Income Program</u>				
Number of Grants				
Per Year	7,100	9,300	14,900	19,300
Five-Year Total	35,500	46,500	74,500	96,500
Number of Below-Market Loans/Housing Cost Supplements				
Subsidized	42,700	40,000	89,000	83,300
Market Rate	17,400	37,700	36,400	78,700
TOTAL	60,100	77,700	125,400	162,000
Number of Eligible Households	350,000	350,000	350,000	350,000

1. Assumes 3 percent down payment.

EXHIBIT 5-14

COMPARISON OF ALTERNATIVE APPROACHES TO RENT STABILIZATION

	Low-Income Program				Mixed Income Program			
	Housing Vouchers		New Construc.	Coop Conversion	Housing Vouchers		New Construc.	Coop Conversion
	FMR	Imputed			FMR	Imputed		
Average Monthly Subsidy ¹								
@ 30 Percent Income	\$225	\$188	\$334	\$221	\$223	\$186	\$280	\$205
@ 40 Percent Income	\$213	\$190	\$240	\$188	\$212	\$190	\$241	\$188
<u>Small Program</u>								
Total Number of Units (per year)								
@ 30 Percent Income Rent Supplement Grant (per year)	30,700 N/A	36,800 N/A	20,700 2,500	31,300 3,700	31,000 N/A	37,200 N/A	28,100 3,300	44,600 5,300
@ 40 Percent Income Rent Supplement Grant (per year)	32,500 N/A	36,400 N/A	29,000 3,500	48,400 5,800	32,600 N/A	36,400 N/A	41,600 4,900	69,200 8,200
Number of Subsidized Units (per year)								
@ 30 Percent Income Rent Supplement Grant (per year)	30,700 N/A	36,800 N/A	20,700 2,500	31,300 3,700	31,000 N/A	37,200 N/A	24,700 2,900	33,700 4,000
@ 40 Percent Income Rent Supplement Grant (per year)	32,500 N/A	36,400 N/A	28,800 3,500	36,800 5,700	32,600 N/A	36,400 N/A	28,700 3,400	36,800 3,900

1. Excludes market rate households.

EXHIBIT 5-14

COMPARISON OF ALTERNATIVE APPROACHES TO RENT STABILIZATION

(Continued)

	Low-Income Program				Mixed Income Program			
	Housing Vouchers		New Construc.	Coop Conversion	Housing Vouchers		New Construc.	Coop Conversion
	FMR	Imputed			FMR	Imputed		
Average Monthly Subsidy ¹								
@ 30 Percent Income	\$225	\$188	\$334	\$221	\$223	\$186	\$280	\$205
@ 40 Percent Income	\$213	\$190	\$240	\$188	\$212	\$190	\$241	\$188
<u>Large Program</u>								
Total Number of Units (per year)								
@ 30 Percent Income								
Rent Supplement	64,100	76,700	43,300	65,200	64,600	77,500	58,700	93,000
Grant (per year)	N/A	N/A	5,200	7,800	N/A	N/A	7,000	11,100
@ 40 Percent Income								
Rent Supplement	67,700	75,900	60,700	76,600	68,000	75,900	87,000	144,200
Grant (per year)	N/A	N/A	7,300	12,000	N/A	N/A	10,300	17,200
Number of Subsidized Units (per year)								
@ 30 Percent Income								
Rent Supplement	64,100	76,700	43,200	65,200	64,600	77,500	51,500	69,800
Grant (per year)	N/A	N/A	5,100	7,800	N/A	N/A	6,200	8,300
@ 40 Percent Income								
Rent Supplement	67,700	75,900	60,100	100,800	68,000	75,900	59,800	76,400
Grant (per year)	N/A	N/A	7,200	11,900	N/A	N/A	7,100	9,100

1. Excludes market rate households.

tions considered here would necessarily eliminate or modify the non-economic provisions of the existing rent stabilization Ordinance.

5.3.1. Substitutes for Rent Stabilization

Earlier sections of this Chapter explored a variety of housing subsidy programs that might assist target beneficiary households more effectively than does the existing system of rent stabilization. Several alternative funding levels were defined, based on the current level of aggregate rent savings realized by eligible households. These funding levels ranged from a minimum of \$83 million to a maximum of \$173 million. In this section our assignment is to examine three alternative tax mechanisms for raising comparable funds from the rental housing industry in the absence of rent stabilization -- a decontrol tax, a transfer tax, and an additional gross receipts tax. For each of these potential funding mechanisms we estimate the pool of funds available for taxation, calculate the approximate tax rates necessary to achieve minimum and maximum funding levels, and consider the incidence of the tax burden and issues of implementation.

Decontrol Tax. This option for raising housing assistance funds would permanently lift all existing rent ceilings as stabilized units became vacant. However, the owner of a decontrolled unit would be liable every year for taxes based on the difference between the actual rent received and the maximum rent that could have been charged had the unit remained occupied and stabilized. To illustrate, suppose that a unit currently rents for \$350. Under the 7% ceiling, the rent next year could be increased to a maximum of \$375 if the unit continued to be occupied by the same tenant. However, if the unit were vacated, thereby becoming permanently decontrolled, and the landlord charged the new tenant a rent of \$400, the landlord would now be required to pay a tax based on the difference between \$400 and \$375. Next year, the hypothetical stabilized rent for the unit would increase to \$401. If the landlord raised the rent to \$450, the new tax liability would be based on the difference between \$450 - \$401, or \$49.

Exhibit 5-15 presents several estimates of the pool of dollars available for taxation in the initial year of such a system. A three-step procedure was used to produce these estimates. First, we estimated the average 1985 rents for decontrolled units. Next, we estimated average 1985 rents for stabilized units. Finally, we used these two average estimates to approximate the total pool of funds available for taxation.⁸

Estimating the rents likely to be paid in 1985 by recent movers requires some assumptions about landlords' likely response to permanent vacancy decontrol. Currently, recent movers pay rents that average 14% more than the rents of stayers. This is partly a result of rent stabilization -- which encourages landlords to obtain the biggest increases they can at turnover -- and partly the result of tenure discounts that are evident in all rental markets. How large a premium would recent movers pay on average in the absence of rent stabilization? Our estimates of Imputed Rents, developed in Chapter 2, suggest that in the absence of controls, recent movers would face an average mark-up of about 10%, while our Market Rent estimates yield a 15% markup.

Therefore, Exhibit 5-15 presents three estimates of 1985 recent mover rents. The first two were obtained by inflating the average 1984 market and imputed rents of recent movers into 1985 terms by applying the 1983-1984 CPI change. This reflects the assumption that, as units became vacant, landlords would begin charging the Market (or Imputed) rents that would occur in the absence of rent stabilization, and that the market rents of recent movers are (on average) 10% to 15% higher than average rents paid by stayers. Our third recent mover rent estimate is calculated by applying a 14% markup to the 1985 rents allowed under rent stabilization. This reflects the assumption that, at least in the short-term, landlords would continue to price turnovers at the same ratio relative to stabilized units. It seems likely that, over time, as an increasing share of the stock was decontrolled, recent mover markups would increasingly be set relative

EXHIBIT 5-15

POOL OF TAXABLE FUNDS IN
INITIAL YEAR OF A DECONTROL TAX

(in \$ millions)

	<u>Rent Adjustment Formulas</u>	
	<u>7%</u>	<u>Cost-Based</u>
Based on Market Rents		
Short-Term	9.6	32.3
Long-Term	27.5	39.5
Based on 14% Mark-Up		
Short-Term	71.9	68.7
Long-Term	71.9	70.2

to market rents rather than controlled rents. However, this does not mean that the gap between recent mover rents and the "shadow" stabilized rents would narrow significantly.

Once estimates of average decontrolled rents have been computed, we estimate average stabilized rents. Average 1984 rents have been increased to 1985 terms using the maximum increase allowable under both the existing 7% ceiling and the Cost-Based Index formula described in Chapter 4. As in Chapter 4, the increase allowed by the Cost-Based Index formula is derived both on the basis of short-term and long-term price trends.

The final step required to produce estimates of the pool of available revenues for a decontrol tax is to compute the difference between average decontrolled rents and average controlled rent, convert this difference to annual terms, and multiply by the total number of units that are expected to turn over. Since about 20% of the renter households surveyed in 1984 were recent movers, we estimate that 20% of the roughly 489,000 stabilized units (or 99,756 units) would be decontrolled in the initial year.

As the figures in Exhibit 5-15 illustrate, a smaller pool of taxable funds would be generated in the initial year of a decontrol tax system than the total amount saved annually by the target beneficiaries through rent stabilization. However, it is important to keep in mind that the full \$83 - \$173 million would not be required initially to offset the lost benefits of stabilization. Since stabilization would remain in effect until units were vacated, many eligible households would continue to benefit from the system and would presumably not require any new form of assistance. Turnover rates among eligible groups appear to be approximately the same on average as the 20% rate observed among all households. As a result, initial funding requirements would probably range from \$17 million to \$35 million in the first year and escalate to the total savings amounts (plus price inflation) over some unknown number of years.

However, even these requirements appear rather large relative to the funds available for taxation. To achieve the lowest funding level (\$16.6 million), a tax rate of between 19% and 34% would be required. At an intermediate rate of 24%, the tax liability for an average decontrolled unit would amount to about \$132, or about two percent of the annual revenues from the unit (\$5,700). The comparable intermediate tax rate necessary to raise the maximum funding level (\$34.7 million) would be 46%. This would yield an average liability of \$254, or about 4.5% of the total income per decontrolled unit.

How would such a system operate as increasing numbers of units became decontrolled? It is impossible to generate year-by-year estimates of growth in the pool of taxable dollars for two basic reasons. First, we do not know how many new units (i.e., units that had not turned over and been decontrolled before) would turn over every year. It seems likely that the incremental number of decontrolled units would be smaller each year until finally the majority of the stabilized stock had turned over at least once. Second, it is difficult to forecast accurately the changing relationship between unstabilized rents and stabilized rents.

Although we cannot track the year-to-year progress of a decontrol tax system, it is reasonable to assume that in the long-run, when virtually all units were decontrolled, such a system would essentially correspond to the initial-year scenario outlined above. Taxes would be imposed on all units (five times the number contributing to the tax base in the first year), and total funding levels would be required (five times the initial-year estimates). However, the long-term relationship between decontrolled and stabilized rents could either expand or diminish.

It must also be noted that application of such a tax raises at least three serious operational problems. First, as the range of estimates in Exhibit 5-14 illustrates, it would be extremely difficult -- if not impossible -- to anticipate on a year-to-year basis what levels of funding would be generated or what levels

would be required as units became decontrolled. Thus, trying to finance a reliable and efficient subsidy program entirely on such a funding system would be quite risky. Second, the tax itself would be complex to administer, since landlords would be taxed on a different basis for each decontrolled unit, where the taxable basis depended upon a unit's current rent, its rent at the time of decontrol, and the number of years since decontrol. Finally, at least at first the brunt of this tax would probably be borne by movers, particularly during the initial years of implementation. As more and more units were decontrolled, the tax burden would gradually spread to the full renter population, but at first the rents of recent movers would certainly increase as landlords attempted to achieve desired rates of return net of the new tax on rental income.

Variations on a Decontrol Tax. We have also been asked to comment on two variations on the decontrol tax. In the first, the owner of a stabilized unit would be given decontrol as an option to keeping the unit stabilized. If the landlord decided upon decontrol, he/she would be subject to the tax but the unit would never return to stabilized status. If the landlord opted for continued stabilization, he/she would be exempt from the tax until the next time the unit was vacated, when the same set of choices would be available again.

In principle this variation need not alter the tax rates that would need to be imposed to offset the losses of benefits suffered by tenants. If a fraction of the housing stock remained unstabilized, an offsetting fraction would continue to benefit from stabilization. Thus, if only 50% of the landlords elected decontrol, funding requirements should fall by about the same fraction. But there would be too many variables at work to be certain that funding requirements during any period would remain in constant proportion to the pool of available tax dollars. Thus, the risks of mismatch that were already great under a mandatory decontrol/tax program would be greatly magnified. If there were a buffer pool available from some other funding source, this problem could, of course, be lessened.

To estimate the proportion of landlords who would opt for decontrol it is necessary to determine why some landlords might choose to pay a tax and achieve decontrol while others would prefer to remain subject to rent stabilization. It seems likely that landlords who have experienced very low turnover rates would select the decontrol option when the opportunity arose. By contrast, landlords who have experienced high turnover rates might not consider rent stabilization as a serious constraint and might therefore opt out of a tax.

To illustrate, suppose two units, owned by two different landlords, are vacated at the same time. Both landlords can charge market rates for these units, whether or not permanent decontrol is elected. If Landlord A expects the new tenant to move out within two or three years, he may decide to remain controlled. When the unit turns over again, he will be able to again charge a market rent, and will have paid no tax in the meantime. Landlord B, on the other hand, may expect his new tenants to remain in-place for five years or more. If so, he would prefer to pay a tax and be able to keep rents at market levels.

The trade-off between the cost of an annual decontrol tax and the benefit of decontrol depends not only on expected turnover rates, but also on the relationship between market rent increases and increases allowed under rent stabilization. If market rents rose rapidly relative to controlled rents (as they did on average over the 1977-84 period), landlords would be more likely to opt for decontrol, unless their tenants typically move every year or two. By contrast, if market rent increases were only slightly higher than controlled rent increases (as they appear to have been in the last year or so), more landlords would opt to avoid the tax, even if they expected tenants to remain in-place for three or four years.

Given that landlords would have only one opportunity to elect permanent decontrol for any given unit, it seems likely that only landlords with very high turnover expectations would take the chance of remaining stabilized. Even though the tax

rates implied by the decontrol options are rather high, most landlords would probably prefer to regain autonomous control over rents. Therefore, it seems unlikely that more than 10% to 20% of units would remain in the rent stabilization system after having become vacant after the optional system had been installed. This would imply a slightly slower rate of decontrol than the mandatory option -- and probably some irreducible residue of stabilized units in chronically high-turnover situations -- but the difference would not be expected to be very large.

The second variation on the decontrol tax approach that we were asked to address is the same as the voluntary decontrol option but with a 25% cap on the markup that a landlord who opted for decontrol could charge. Whether and how often this cap would come into play would depend to some extent on the tax rate applied to the difference between stabilized and decontrolled rents, as well as on all of the other variables cited earlier. Based upon the figures and estimates developed in the study, and the prospect that the tax rate would not be much different from that required for the mandatory decontrol program, the 25% cap would not be expected to have much operational effect.

Transfer Tax. The second funding mechanism considered would impose a tax on stabilized properties at the time they were sold. Total rent revenues in the year prior to sale would be subject to taxation.

Three alternative measures of average rent revenues were used -- average 1984 rents as reported in our tenant survey (\$401 per month or \$4,812 annually), average 1983 per unit revenues as reported in our landlord survey inflated to 1984 terms (\$3,673 annually), and average 1983 per-unit revenues among properties sold in 1984 from the DAMAR sample (\$4,642 annually). Two estimates of property turnover rates were used -- a short-term measure based on 1984 sales (6.7%), and a long-term measure based on the average for the 1979-1984 period (7.97%).

Exhibit 5-16 presents several estimates of the pool of taxable funds that such a system could be expected to generate if implemented today. Although much larger than the tax base of the

EXHIBIT 5-16

POOL OF TAXABLE FUNDS IN INITIAL YEAR OF A TRANSFER TAX

(in \$ millions)

	<u>Property Turnover Rate</u>	
	<u>Short-Term</u>	<u>Long-Term</u>
Based on		
Tenant Rents	157.7	187.5
Landlord Revenues	120.3	143.1
DAMAR Revenues	152.2	180.9

vacancy decontrol tax, this mechanism appears to generate a pool of taxable funds that is small relative to the required funding levels. Specifically, the minimum funding level (\$83 million) would require landlords who sold their properties to pay a tax equal to roughly half the previous year's total revenues. This implies an average liability of about \$2,350 per unit, or about 6.6% of the unit's value. In other words, this mechanism would roughly translate into a 6%-7% tax on the total sales price of rental properties. Tax rates approximately twice as high (i.e., 12%-14%) would be required to achieve the maximum funding level of \$173 million.

If imposed all at once these tax rates would produce the total funding required to replace the benefits lost if the existing system of rent stabilization were discontinued all at once. However, if controls were lifted gradually -- as in the previous option -- lower initial funding levels would be required. One such approach might be to lift stabilization as properties were sold, although this might encourage a rash of paper transactions, followed by a return to more normal turnover patterns after the majority of the stock had achieved decontrol. If decontrol were linked to property turnover, and if turnover rates remained fairly stable at 6% to 8% per year, then tax rates could initially be lower, since the majority of eligible households would continue to receive existing rent stabilization benefits. However, in the long term, tax rates would have to rise, since the turnovers occurring in any given year would have to support the full funding level required to replace rent stabilization.

The probable incidence of such a transfer tax is somewhat difficult to anticipate. Landlords who held their properties would not be directly affected, but it seems likely that, in the long-term, some extra rent increases would occur as landlords attempted to preserve their after-tax rates of return. If rent stabilization were lifted immediately for all units, this increase would probably be distributed across the entire tenant population, so that recent movers would not bear a disproportion-

ate burden. If, on the other hand, decontrol occurred gradually, the adverse affect on recent movers would probably be greater in the short-term.

Additional Gross Receipts Tax. The third funding mechanism examined would provide for immediate decontrol of all stabilized units, and would impose an increment to the annual gross receipts tax on residential rent revenues. In other words, all landlords would pay an annual tax, based on the preceding year's total revenues and unconnected to turnover, building cost or the characteristics of building residents. To estimate the 1985 pool of taxable rent revenues to which such a tax might be applied, we have two data sources:

- * The tenant survey yields an average monthly per-unit contract rent in 1984 of \$401 per month, or \$4,812 annually. Given an estimated 489,000 stabilized units, the total pool of funds available for taxation is $489,000 \times \$4,812 = \2.353 billion.
- * The landlord survey reports average annual revenues in 1983 of \$3,359 per unit. We can inflate this estimate to 1984 terms using the average 1977-83 revenue growth rate reported by Los Angeles landlords (9.34%). This yields a per-unit figure of \$3,673. Multiplying this per-unit estimate by the 489,000 stabilized units yields a pool of taxable funds of \$1.796 billion.

The funding requirements under this option again range from a minimum of \$83 million to a maximum of \$173 million. These correspond to our minimum and maximum estimates of benefits currently going to eligible households (see Exhibit 5-1).

Of the three funding mechanisms considered as substitutes for the existing system of rent control, this option draws upon the broadest tax base and therefore yields the lowest rates. Assuming the stabilization was discontinued at the same time that the tax took effect, the amount needed to be raised to offset the net benefits lost by the target beneficiary groups would be the full \$83-\$173 million. This works out to mean that landlords would be required to pay an additional gross receipts tax of between 4% and 10% of rental income, for an average additional tax liability of between \$192 and \$481 per unit.⁹ Again, this tax would be spread evenly across the entire stock of rental units,

rather than applying only to units vacated or properties sold. Like the other taxes considered here, an additional gross receipts tax might be passed through to tenants in the form of higher rents. However, since all units would be affected, and again assuming that stabilization was discontinued immediately, the burden would be broadly distributed.

5.3.2 Supplements to Rent Stabilization

This section examines three alternative funding mechanisms that would operate in conjunction with rent stabilization. The central concept behind each of these options is to supplement the benefits of stabilization in such a way as to ensure that poor and elderly households spend no more than the Federal affordability standard of 30% of their incomes for housing. As discussed in Chapter 2, the existing rent stabilization system somewhat reduces the rent burdens of a substantial share of Los Angeles households. Still, many low- to moderate-income and elderly households bear housing costs in excess of generally accepted affordability standards. Exhibit 5-17 reports the share of households in our two eligibility groups with 1984 gross rent-to-income ratios over 30% and 40%, respectively. Clearly, rent stabilization has not eliminated housing affordability problems for all low- and moderate-income households of Los Angeles.

Exhibit 5-17 also provides estimates of the aggregate additional money benefits that would need to be paid, above and beyond the benefits of rent stabilization, if the program objective were to bring rent-to-income ratios down to 30% (or 40%) for all eligible households. In other words, if the existing system of rent stabilization were retained, this is how much additional funding would have to be raised to ensure that housing costs were affordable for all eligible households. Note that these funding requirements are considerably larger than the aggregate benefits already received by eligible households from stabilization, ranging from a minimum of \$128 million to a maximum of \$287 million.

EXHIBIT 5-17

SUPPLEMENTAL FUNDING REQUIREMENTS
TO ENSURE HOUSING AFFORDABILITY

<u>Eligibility Groups</u>	<u>Gross Rent In Excess of 30% Income</u>	<u>Gross Rent In Excess of 40% Income</u>
Very Low and Low Income	68%	40%
Very Low, Low, and Moderate Income and all Elderly	51%	28%
	<u>Aggregate Amount In Excess of 30% Income</u>	<u>Aggregate Amount In Excess of 40% Income</u>
Very Low and Low Income	\$267 million	\$128 million
Very Low, Low and Moderate Income and all Elderly	\$287 million	\$130 million

It is also important to note that these funding levels are based on current rents and give no consideration to housing quality. If, after implementation of the new program, a substantial number of eligible households moved to more expensive units, the funding requirements of the program could expand dramatically. Given the nature of the subsidy described, this outcome is highly likely. Presumably, a rental ceiling could be incorporated into the adjustment formulas. Nevertheless, the figures in the chart are probably at the low end of the range of plausible estimates of funding requirements.

The remainder of this section explores three optional mechanisms that have been identified by the City as possible ways of meeting these funding requirements -- a vacancy tax, an annual unit tax, and an "unintended benefits" tax. As in the preceding section, we identify the pool of taxable funds available under each of these alternatives, calculate the implied tax rates, and discuss the incidence of tax burdens.

Vacancy Tax. The first mechanism would retain the existing rent stabilization system and add a tax on landlords whenever units turned over. In other words, landlords would continue to have the right to raise rents without limit for new tenants, but would pay a tax on the previous year's rent for all units that turned over.

Using average annual 1984 per-unit rents from the tenant survey (\$4,812), estimating an average turnover rate of 20.4% (again based on tenant data) and an estimated 489,000 stabilized units, the pool of taxable funds that would be generated in 1985 amounts to roughly \$480 million. An alternative estimate would be obtained from the landlord data: the average annual 1983 revenue per unit is reported at \$3,359, and when inflated to 1984 it yields an annual figure of \$3,673; the average turnover rate is reportedly about 15.5%. These data yield an estimated pool of about \$278 million.

Funding requirements under this option range from a minimum of \$128 million to a maximum of \$287 million. These correspond to our minimum and maximum estimates of excessive housing burdens

currently paid by eligible households (see Exhibit 5-17). Tax rates can be estimated at minimum and maximum funding levels, using both estimates of the pool of taxable dollars. When the tenant data are used to estimate the tax pool (\$480 million), one derives a minimum necessary tax rate of about 27% and a maximum rate of just under 60%. When the landlord survey is used to estimate the tax pool (\$278 million) one identifies a minimum necessary tax rate of about 46%. At the maximum funding level, however, the total taxable pool would not support the cost even if taxed at 100%, since \$480 million would be needed and only \$287 million would be generated by the turnover rate.

The brunt of this tax would almost certainly be borne by movers, since landlords would attempt to pass on the cost and rents on continuously occupied units would remain regulated. Our earlier analysis has shown that recent movers already pay a large proportion of the subsidy provided by the existing rent stabilization system. This option would necessarily increase the burden borne by a relatively small segment of the City's population.

Annual Unit Tax. This option would extend the tax base from recently vacated units to the entire stock of stabilized units. Again, the existing system of rent stabilization would be retained, but supplemental housing assistance funds would be raised by taxing the prior year's rent revenues for all units, not just those vacated.

This system would generate the same pool of taxable funds as the supplement to the gross receipts tax that was discussed in the prior section. Using 1984 rents as reported in the tenant survey, the pool would total \$2.353 billion in 1985; using the landlord survey data, it would total \$1.796 billion. The tax rate necessary to yield the needed funding would range between 5% and 12% of annual revenues, based on the tenant survey data. Based on the landlord survey, the tax rate would range from 7% to 16%.

While these rates are lower than those required for the vacancy tax, the burden would still be likely to fall primarily on the 20% of renter households that move in any year. Even

though every unit would be taxed under this option, landlords could not pass on the cost to the occupants of the units that remained occupied and stabilized. Therefore, the impact of this mechanism on recent-mover rents would be likely to be about the same as the impact of a vacancy tax.

"Unintended Benefits" Tax. The final funding mechanism considered here represents an attempt to improve upon the distribution of benefits and costs that has resulted from the existing system of rent stabilization. Funds would be raised by taxing higher income renters who appeared to be benefiting from stabilization. These funds would then be used to reduce the housing costs of lower income renters who bear cost burdens greater than 30% (or 40%) of income. Specifically, nonelderly households with moderate- or upper-level incomes (by HUD standards) would be taxed on their "unintended benefits," defined as the difference between 30% of their income and their actual housing costs.

Exhibit 5-18 presents data on the housing expense burdens of moderate- and upper-income, nonelderly renters. The vast majority of these households (91%) pay less than 30% of their income for rent. However, as the Exhibit shows, these housing expense burdens are not low primarily because of rent stabilization. Among those with low rent-to-income ratios, the average difference between their actual gross rent and 30% of their income is \$441 per month, while the average benefit attributable to rent stabilization is only \$3 to \$4 per month. In fact, among the non-elderly, upper-income households with low housing cost burdens, rent stabilization is estimated to result in a net cost of \$19-23 per month above the rents they would pay if stabilization had never been enacted. Thus, it must be noted that these households are already paying part of the subsidy provided by the existing stabilization system.

Nevertheless, if non-elderly, moderate- and upper-income households were taxed on the difference between their gross rents and 30% of income, a total pool of about \$1.016 billion would be available for taxation. If the tax rate were set at the amount necessary to raise the dollars required to bring the other groups

EXHIBIT 5-18

HOUSING EXPENSE BURDENS AMONG NONELDERLY,
MODERATE- AND UPPER-INCOME HOUSEHOLDS

	<u>Nonelderly Renter Households</u>		
	<u>Moderate Income</u>	<u>Upper Income</u>	<u>Total</u>
Share with gross rents below 30% of income	82%	97%	91%
For households with gross rent-to-income ratios < 30%:			
Mean difference	\$185	\$581	\$441
Mean rent control benefit - imputed rent	\$ 42	-\$19	\$ 3
- market rent	\$ 89	\$ 16	\$ 42

of tenants into the affordable range, the rate would be between 12.6% and 28.2%. If enacted, the result would be that 43% of all renter households would pay an average tax of between \$667 and \$1,492 annually -- about 1.9% to 4% of income for the average moderate- to upper-income renter household (which has an average income of about \$35,800).

It seems very probable that explicitly targeting a tax of this nature on the most affluent segment of the renter population would add substantially to existing incentives for these households to become owner-occupants. Over time, the rental housing stock would be expected to decline relative to the owner-occupied stock, and quite likely in absolute terms as well.

5.3.3 Summary Presentations

Exhibit 5-19 provides a one-page summary of all of the options examined that would substitute for rent stabilization. Exhibit 5-20 does the same for all of the options that would supplement stabilization. As observed in each case, all options would involve substantially higher tax rates that have been traditionally levied in Los Angeles, and most would apply to tax bases composed of relatively small portions of the population, so that the burden would be sharply felt.

EXHIBIT 5-19

SUMMARY OF TAX MECHANISMS
SUBSTITUTES FOR RENT STABILIZATION

	<u>Decontrol Tax</u>	<u>Transfer Tax</u>	<u>Additional Gross Receipts Tax</u>
Units Subject to Taxation	All units that have been vacated and hence, are permanently decontrolled	Units that are sold	All units
Frequency of Taxation	Annually	At time of sale	Annually
Pool of Taxable Dollars (initial year)	\$49.1 million to \$75.4 million ^a	\$120.3 million to \$187.5 million	\$1,796 million to \$2,353 million
Tax Rate			
Minimum Funding Level (\$82.9 million)	22.02% - 33.81% of difference between actual and controlled rent ^b	44.21% - 68.91% of rent revenues	3.52% - 4.62% of rent revenues
Maximum Funding Level (\$173 million)	46.02% - 70.67% of difference between actual and controlled rent	92.27% - 143.81% of rent revenues	7.37% - 9.65% of rent revenues

a. Assumes that controlled units continue to be subject to the existing Seven Percent adjustment formula, and that only 20% of units are vacated in the first year.

b. Assumes that only 20% of funding is required in initial year, since only 20% of stock is decontrolled. For comparison to other tax rates, these estimates represent 2.5% - 3.5% of total rent revenues for the minimum funding level, and 5.3% - 7.2% of rent revenues for the maximum funding level.

EXHIBIT 5-20

SUMMARY OF TAX MECHANISMS
SUPPLEMENTS TO RENT STABILIZATION

	<u>Vacancy Tax</u>	<u>Annual Unit Tax</u>	<u>"Unintended" Benefits Tax</u>
Units Subject to Taxation	Units vacated and newly occupied	All units	Non-elderly renter households with moderate to upper incomes and rents less than 30% of income.
Frequency of Taxation	Year of turnover	Annually	Annually
Pool of Taxable Dollars (initial year)	\$278.4 million to \$480.0 million	\$1,796 million to \$2,353 million	\$1,016 million
Tax Rate			
Minimum Funding Level (\$128 million)	26.67% - 45.98% of rent revenues	5.44% - 7.13% of rent revenues	12.5% of "unintended benefits" ^a
Maximum Funding Level (\$287 million)	59.79% - 103.09% of rent revenues	12.20% - 15.98% of rent revenues	28.2% of "unintended benefits"

a. "Unintended" benefits are equal to the excess of 30 percent of income over gross rent. These tax rates represent about 2% of household income for the minimum funding level and about 4% of household income for the maximum funding level.

1It should be noted that this does not include all people in these income categories in the City, but only the portion of them who live in rent-stabilized properties.

2Also, of course, it would be possible to set the subsidy equal to the actual difference between the rent paid by a target group household and 30% of income if that difference were positive. However, projecting the effects of this program requires knowing the markups in rent that would be charged to currently stabilized tenants immediately upon discontinuance of stabilization. Over time, one would expect these rents to rise to the Imputed Rent levels, but it is very difficult to estimate how long this would take. Therefore, while Imputed Rents represent a reasonable long-term surrogate for actual unstabilized rents, they may not be in the near term.

3Estimated Market Rents -- which are lower than FMRs but marginally higher than Imputed Rents -- would have produced yet another standard of housing costs. However, since the estimated subsidies produced by Imputed Rents are close to those produced by Market Rents, we have not employed them here.

4See R.J. Struyk and M. Bendick, Jr., eds., Housing Vouchers for the Poor, Lessons from a National Experiment, The Urban Institute, 1981.

5These figures were derived by estimating the costs of a prototypical two-bedroom unit. This figure was then adjusted upward or downward for larger and smaller units by using cost differentials derived from a comparative analysis of development costs (see Schnare, et al, Costs of HUD Multifamily Projects, 1981). Similar figures can be derived if one applies the differentials for HUD net construction FMRS.

6The figures presented in the text refer to a new construction program. Comparable results would arise if one considered substantial rehabilitation. Previous studies have found that the total cost of substantially rehabilitated units are about 5% less than the costs of "otherwise similar" new construction. As a result, the figures presented in the text could be deflated by 5% to provide rough estimates of average subsidies, and inflated by 5% to derive feasible production levels.

7Note that these sale prices and cost estimates include no allowance for rehabilitation costs prior to conversion to coop and sale. Many with experience with Los Angeles conversions report that such costs often must be paid to effect conversion. To the extent this is true, costs are understated here.

8All rent measures used in the discussion of funding alternatives refer to contract rents, unless specifically noted.

9While these rates are much lower than those involved in other funding options, it is important to note that they are dramat-

ically higher than the existing gross receipts tax rate of 0.125%.



ARTHUR YOUNG

515 South Flower Street
Los Angeles, California 90071

April 19, 1985

Ms. Francine Rabinovitz
Vice President
Hamilton, Rabinovitz, Szanton
& Alschuler, Inc.
3345 Wilshire Boulevard
Suite 407
Los Angeles, California 90010

Dear Ms. Rabinovitz:

At your request, we have performed certain computerized procedures on a machine-readable file of Los Angeles Landlord Survey data which was supplied to us by John McConahay of HRS&A and another series of computerized tests on a separate file provided by Ann Schnare of the Urban Institute. The tests have been grouped into four (4) categories and were performed on the noted files:

o	Survey sample	HRS&A Urban Institute
o	Reasonableness tests	Urban Institute
o	Unusual averages	Urban Institute
o	Expenses as a percent of income	Urban Institute

SURVEY SAMPLE. From the HRS&A file which contained 261 surveys each with 234 data elements, we selected a statistically random sample of 32 records. Each data element was agreed to the original survey. Based upon this test we found 11 surveys had no errors and the remainder contained between one and five errors a survey for a total of 39 errors. Therefore, the error rate based on the sample we tested was .52%. We believe that any significant errors in this sample affecting the remainder of the population will be identified in the tests described in the following sections.

From the Urban Institute file which contained 210 surveys we selected the same sample items which had been chosen from the HRS&A file. Seven of these selected surveys had been deleted leaving a sample of 25 to be reviewed. The detailed data elements on the Urban Institute file were also agreed to the

Ms. Francine Rabinovitz
April 19, 1985
Page Two

original survey. The test revealed 11 surveys which had no errors and 14 surveys which had between 1 and 5 errors each, for a total of 365 errors. This equates into a .62% sample error rate.

A subsequent review was made of the HRS&A tape and was limited to the same 25 surveys discussed in the preceding paragraph. Of these 25 surveys, 7 had no errors and the remaining 18 surveys contained one to five errors for a total of 33 errors. This results in an error rate based on the sample tested of .56%. According to a study performed by N. Carweit and E. D. Meyers, Jr., error rates of less than 4% are considered adequate and error rates of less than 2% are considered excellent. The error rate in this survey is less than .63 of 1%.

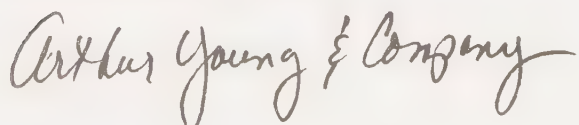
REASONABLENESS TESTS. We designed a series of 20 tests based on the survey which would indicate an error or unusual condition. Some sample tests were negative total property income and 11 or more points charged for the mortgage. When minor differences and rounding are ignored, we found error or visual item rates of less than 10% for each test.

UNUSUAL AVERAGES. We designed some subjective averages based on the survey which should verify data accuracy. Examples of these averages were property income per unit and total operating costs per unit. Each average was computed for each survey where the data was provided and the mean for each average was calculated. We then identified the number of surveys which varied from the mean by more than 50%. The percentage of surveys varying by more than 50% from the mean was more than 20% for each average.

EXPENSES AS A PERCENT OF INCOME. Based on the wide ranges noted in the preceding averages, we computed each of the expense categories (salaries, utilities, etc.) as a percentage of total income for each survey. With the exception of financing costs which varied widely across the surveys, each individual expense category and total operating expenses exhibited an expected percentage relationship to income.

We would be pleased to review our detailed results with you or answer any questions at your convenience.

Very truly yours,



PROJECT TEAM

1984 LOS ANGELES RENTAL HOUSING STUDY

HAMILTON, RABINOVITZ, SZANTON & ALSCHULER INC.

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